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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-1474

DOUGLAS P. FIELDS and ALAN E. SANDBERG,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

SIMON H. RIFKIND
345 Park Avenue
New York, New York 10022
(212) 644-8000
Attorney for Petitioner Douglas P. Fields

Of Counsel:
MAX GITTER
WILLIAM B. POLLARD
PAUL, WEISS, RIFKIND, WHARTON & GARRISON

NORMAN S. OSTROW
375 Park Avenue
New York, New York 10022
(212) 832-3611
Attorney for Petitioner Alan S. Sandberg

Of Counsel:
FRANK WRIGHT
GRAND & OSTROW

TABLE OF CONTENTS

	PAGE
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes and Regulations Involved	4
Statement of the Case	4
The Facts	4
Proceedings Below	7
The District Court	7
The Court of Appeals	9
Rehearing	12
Reasons for Granting the Writ	13
I. The Second Circuit's Unwarranted, Ominous Expansion of SEC Disclosure Laws Creates a Conflict Among the Circuits	13
The Panel's Far-Reaching Error	13
The Conflict	18
II. The Court Below Erred in Upholding the SEC Staff's Widespread Abuse of the SEC's Published Rules on Criminal References	19
III. The Decision Below Conflicts With the First Circuit and Unduly Restricts the Supervisory Power of the District Courts to Deal With Government Misconduct	22
CONCLUSION	25

Table of Authorities

PAGE

Cases

Ash v. *LFE Corp.*, 525 F.2d 215 (3d Cir. 1975) 18

Browning Debenture Holders' Committee v. *DASA Corp.*, 560 F.2d 1078 (2d Cir. 1977) 18

Cort v. *Ash*, 422 U.S. 66 (1975) 16

Dixon v. *District of Columbia*, 394 F.2d 966 (D.C. Cir. 1968) 24

Freedman v. *Barrow*, 427 F. Supp. 1129 (S.D.N.Y. 1976) 18

Golub v. *PPD Corp.*, 576 F.2d 759 (8th Cir. 1978) ... 18

Green v. *Santa Fe Industries*, 430 U.S. 462 (1977) .. 16

Int'l Brotherhood of Teamsters, Chauffeurs, Warehousers & Helpers of America v. *Daniels*, 47 U.S. L.W. 4135 (Jan. 16, 1979) 2

Robbins v. *Banner Industries, Inc.*, 285 F. Supp. 758 (S.D.N.Y. 1966) 18

Rodman v. *United States*, 519 F.2d 1058 (1st Cir. 1975) 4, 9, 11, 19, 22, 23

Santobello v. *New York*, 404 U.S. 257 (1971) 25

Securities and Exchange Commission v. *Sloan*, 436 U.S. 103 (1978) 3

Service v. *Dulles*, 354 U.S. 363 (1957) 21

Shapiro v. *Belmont Industries, Inc.*, 438 F. Supp. 284 (E.D. Pa. 1977) 15, 18

Sherman v. *United States*, 356 U.S. 369 (1958) 24

TSC Industries, Inc. v. *Northway, Inc.*, 426 U.S. 438 (1976) 3, 13, 15

PAGE

United Housing Foundation, Inc. v. *Forman*, 421 U.S. 837 (1975) 2

United States ex rel. Accardi v. *Shaughnessey*, 347 U.S. 260 (1954) 21

United States v. *Bloom*, 450 F. Supp. 323 (E.D. Pa. 1978) 19, 21

United States v. *Dondich*, 460 F. Supp. 849 (N.D. Cal. 1978) 19

United States v. *McLeod*, 385 F.2d 734 (5th Cir. 1967) 24

United States v. *Merz*, 580 F.2d 342 (8th Cir. 1978) 19

United States v. *Minnesota Mining & Manufacturing Co.*, 551 F.2d 1106 (8th Cir. 1977) 19

United States v. *Paiva*, 294 F. Supp. 742 (D.D.C. 1969) 24

United States v. *Phillips*, 577 F.2d 495 (9th Cir.), *cert. denied*, 99 S. Ct. 154 (1978) 16–17

United States v. *Rabbitt*, 583 F.2d 1014 (8th Cir. 1978) 17

Vitarelli v. *Seaton*, 359 U.S. 535 (1959) 21

Yellin v. *United States*, 374 U.S. 109 (1963) 21, 23

Statutes and Regulations

15 U.S.C. § 77q(a) 7

15 U.S.C. § 77(t) 19

15 U.S.C. § 78d-1(a) 20

15 U.S.C. § 78n(a) 7, 12

15 U.S.C. § 78p(b) 11, 12, 14

15 U.S.C. § 78u 19

18 U.S.C. § 371 7

28 U.S.C. § 1254(1) 2

17 C.F.R. § 200.10 19

17 C.F.R. § 200.19(b) 20

17 C.F.R. § 240.14a-101 12

Other Authorities

PAGE

Cary, *Federalism and the Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663 (1974) 16

Hill, *The Bill of Rights and the Supervisory Power,* 69 COLUM. L. REV. 181 (1969) 25

R. Karmel, Jurisdictional Concerns in Securities Law Enforcement (Feb. 23, 1978) (Address Before the Federal Bar Council) 25

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MONTGOMERY'S AUDITING (9th Ed. 1975) 15

Note, *Supervisory Power in the United States Courts of Appeals,* 63 CORN. L. REV. 642 (1978) 25

Note, *The Judge-Made Supervisory Power of the Federal Courts,* 53 GEO. L.J. 1050 (1965) 25

Note, *The Supervisory Power of the Federal Courts,* 75 HARV. L. REV. 1656 (1963) 25

L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE (3d Ed. 1972) 15

43 SEC ANN. REP. (1977) 19

The SEC: Going Too Far Too Fast, BUSINESS WEEK, November 27, 1978 25

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No.

DOUGLAS P. FIELDS and ALAN E. SANDBERG,

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v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners Douglas P. Fields and Alan E. Sandberg ask that a writ of certiorari issue to review the judgment of the Court of Appeals for the Second Circuit, entered on September 14, 1978, as corrected by order dated February 14, 1979.

Opinions Below

The majority opinion of the Court of Appeals (Feinberg and Timbers, JJ.), as corrected, and the concurring opinion of the Court of Appeals (Mansfield, J.), are not yet officially reported. They appear as Appendix C to this petition. The opinion of the United States District Court for the Southern District of New York (Haight, J.), not officially reported, appears as Appendix A to this petition.

Jurisdiction

The judgment of the Court of Appeals was entered on September 14, 1978. A timely petition for rehearing with suggestion for rehearing *en banc* was filed October 16, 1978. On February 14, 1979, the Court of Appeals amended its original opinion and denied in all other respects the petition for rehearing. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

Questions Presented

The Second Circuit (Timbers, J.) adopted an all-embracing concept of SEC disclosure that is far broader than the expansive definitions of "security" struck down in *Daniels** and *Forman.** The court held that petitioners were required first to surmise that their prior conduct "may well" have violated some provision of law and therefore to disclose such conduct in SEC filings. The panel's rationale would compel a director to anticipate in SEC filings even claims of violation of state law and thus would open the federal courts to ordinary stockholder's derivative suits. Or, as occurred here, a prosecutor barred by the statute of limitations from indicting for alleged violations of section 16(b), the Hobbs Act, the antitrust laws, or other statutes may now indict a corporate officer for his failure to confess the underlying offense in a subsequent SEC filing.

At the same time, the Second Circuit condoned a procedural excess by the SEC staff that has more awesome impact than did the misuse of the SEC stop-order device

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* *Int'l. Brotherhood of Teamsters, Chauffeurs, Warehousers, & Helpers of America* v. *Daniels*, 47 U.S.L.W. 4135 (Jan. 16, 1979); *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975).

halted in *Sloan.** The court below termed "commendable" a now-widespread practice which has permitted the SEC staff to refer scores of cases for criminal prosecution without the Commission approval required by Congress.

Specifically, the questions presented are:

1. Does the *Northway*** definition of "materiality" mean that a corporate officer must disclose a financially *im*material transaction in an SEC filing *because* that transaction "may well" have violated the law—when that transaction was never adjudged to violate the law, when no litigation had been commenced alleging that it violated the law, and when he contends that it does not violate the law?

We submit that the answer is "no" and that the Second Circuit's decision creates bad new law and conflicts with decisions in two other circuits.

2. May the SEC staff routinely disregard statutes and regulations that indisputably require full *Commission* approval for criminal references, on the excuse that delivery of the SEC file to a prosecutor—and even calls to the prosecutor urging that the SEC "really want[s] to get" the defendants—do not constitute a "criminal reference" but are merely "preliminary communications"?

We submit that the answer is "no" and that the Second Circuit's adoption of the SEC's semantic distinction not only is erroneous (and contrary to a stipulation in the trial court), but also presages Orwellian "newspeak."

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* *Securities and Exchange Commission* v. *Sloan*, 436 U.S. 103 (1978).

** *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976).

3. Does a federal district court have the supervisory power to dismiss an indictment on account of "ignoble," "deceitful," and "duplicitous" government conduct when there is no longer available to it any other effective remedy for that misconduct?

We submit that the answer is "yes" and that the Second Circuit's contrary holding conflicts with the First Circuit's decision in *Rodman* v. *United States*, 519 F.2d 1058 (1st Cir. 1975).

Statutes and Regulations Involved

The pertinent provisions of the Securities Act of 1933, of the Securities Exchange Act of 1934, of the Code of Federal Regulations, and of the SEC Manual of Administrative Regulations are set out in the statutory addendum ("Add.") annexed hereto.

Statement of the Case

The Facts

Petitioners Fields and Sandberg (and co-petitioner Friedman) were and are officers of TDA Industries, Inc. ("TDA"), a small, highly successful public corporation whose shares are traded over the counter. (A.* 8)

In January 1975, petitioners made a disclosure of facts to the staff of the New York Regional Office of the SEC, and their attorneys commenced discussions expressly seeking a resolution of all ongoing government inquiry into their affairs. As the District Court found, a principal purpose of the discussions—repeatedly voiced by petitioners' counsel—was to ensure that the SEC would not make a

* "A" refers to the Appendix to this petition.

criminal reference to the Justice Department. (A. 10-11, 85-86)

In February 1975, the Commission entered a *formal* order of *private* investigation into the matters disclosed by petitioners. (A. 12) By mid-June, the SEC staff had satisfied itself that petitioners' disclosures were complete and accurate and told their attorneys that it was prepared to proceed to a settlement. Six months later, after lengthy additional negotiations, the SEC concluded what was from its point of view a "superb" civil settlement. (A. 13-23, Tr.* 995-999) The many onerous terms extracted from petitioners included: payment by the defendants of some $585,000; provisions barring petitioner Fields for two years from serving as chief executive officer of TDA and as a director of two corporations, and from voting his TDA stock; and lifetime disbarment of co-petitioner Davis from practice before the SEC—theretofore the mainstay of his legal practice. (A. 12, 21-23)

The SEC was represented in the negotiations by two staff attorneys, Tucker and Perlmutter. Both were acutely aware of petitioners' oft-expressed objective of concluding a comprehensive settlement that would ensure no criminal reference. Indeed, they affirmatively represented to a lawyer for a prospective TDA director that there would be no criminal reference—and that representation was in turn communicated to petitioner Fields. (A. 12, 17-18, 31, 88)

Yet, in what was found to be a "calculated and deliberate" effort to "deceive" petitioners and safeguard the "superb" civil settlement they were negotiating, the SEC staff concealed (a) that they would not forbear from referring the matter, and (b) that the staff *already* had referred it for criminal prosecution. (A. 35-36)

* "Tr." refers to the transcript of the hearing conducted by the District Court, part of the record on appeal.

In the Fall of 1975, while actively negotiating with petitioners' attorneys—and without any authorization from the Commission, its General Counsel, or the Director of its Division of Enforcement, as required by law—the staff not only repeatedly called the United States Attorney about the case, but also actively recommended prosecution, urging "*we really want to get* [*the defendants*]" (A. 19; emphasis added).

When the SEC settlement was agreed to in principle, but before it was signed, Tucker and Perlmutter continued actively to encourage a criminal prosecution—still without Commission authorization. They called the prosecutor and sent him the SEC's pleadings. (A. 20)

But at the same time, the SEC staff members, afraid they would jeopardize petitioners' final consent, carefully cautioned the prosecutor to stay his hand until the staff concluded the settlement—even though the staff recognized that there was a "statute of limitations problem" (A. 19-20, Tr. 1333).

After the settlement, in early 1976, in plain violation of SEC regulations, the staff sent the SEC "private" investigative file to the U.S. Attorney. (Some fourteen months later, in the middle of the eleven-day hearing in the District Court, the government tried to cure the latter violation by obtaining a *nunc pro tunc* order of the Commission "authorizing" that earlier delivery of the file. (A. 20-21, Tr. 8, 793-95))

Ten months after the SEC settlement was concluded, on *November 8, 1976,* the government filed a twelve-count indictment against petitioners. (A. 3-4, 81-82)

The underlying wrongdoing alleged in the indictment included what the Second Circuit called the "ERD kickbacks."* Briefly, the ERD transactions were two sales of TDA letter stock in *April* and *May, 1971,* by fourteen TDA stockholders. The indictment alleges that petitioners engineered the sales to a third party, who in turn sold the stock at a profit of $435,000. Petitioners, it is alleged, were to receive 70% of this profit. (A. 4-6, 76-77)

When the grand jury handed up the indictment on *November 8, 1976,* the alleged crime of committing the ERD "kickbacks" was time-barred. In order to indict, therefore, the prosecutor was forced to strain to find a means by which to circumvent the five-year limitations bar. Hence, the indictment alleges not the offense of committing the substantive transactions themselves, but a securities law violation—of failing to disclose the ERD transactions in a November 10, 1971 *TDA* prospectus prepared in connection with a public offering of its stock, and in a proxy statement mailed to *TDA* shareholders in December, 1971.** (A. 4-6, 49-50)

Proceedings Below

The District Court

Petitioners moved to dismiss the indictment on the grounds

a) that it had been procured in breach of an agreement not to criminally refer the matter to the Justice Department

* The Second Circuit's opinion dealt briefly with non-disclosure of another transaction, the so-called "Westcalind kickbacks" (A. 103). If this Court grants plenary review, we shall show that the panel's decision as to that "non-disclosure" also was erroneous.

The indictment contains various additional charges against various petitioners that are not directly involved in this Court, except to the extent that petitioners challenge substantially the entire indictment as the product of government misconduct.

** Specifically, the indictment charges conspiracy (18 U.S.C. § 371) and violations of the criminal provisions of the Securities Act of 1933 (15 U.S.C. § 77q(a)) and of the Securities Exchange Act of 1934 (15 U.S.C. § 78n(a)).

and that the governme: fraudulently had led petitioners to believe that no such referral had taken place;

b) that, irrespective of the agreement, the government's misconduct was so egregious as to call for dismissal under the court's supervisory powers; and

c) that the criminal reference and recommendations for prosecution violated the SEC's own rules and regulations.

Alternatively, petitioners argued, the indictment failed to allege a crime under the securities laws.

The District Court (Haight, J.) held an eleven-day hearing, and on June 2, 1977, in an 82-page memorandum opinion and order, granted the bulk of petitioners' motion by striking substantial portions of the indictment. (A. 1-74)

Judge Haight's central finding was that the government, acting through its representatives at the SEC, had "played an ignoble part" in leading petitioners to believe there would be no criminal reference, and in concealing the fact that a reference already had been made. After a painstaking review of the facts, he found the conduct of the SEC staff "fraudulent," "misleading," "calculating and deliberate," "deplorable," and "wrongful"* (A. 21, 34, 36).

On the issue of remedy, Judge Haight carefully analyzed the alternatives still available to him and concluded that any remedy short of dismissal of the tainted portions of the indictment would be ineffectual** and inconsistent with

* Although Judge Haight declined to hold that there had been an *express* agreement not to criminally refer this case, he did find that the SEC "affirmatively indicated that there would be no criminal reference" (A. 32).

** The parties clearly could not be placed in the *status quo ante* by reopening the SEC "civil" settlement. For example, it would have been impossible to reverse the sanction which barred petitioner Fields from voting his stock or serving as an officer or director of TDA—that "sentence" already had been substantially served.

safeguarding judicial integrity. In so holding, he relied on the closely analogous decision of the First Circuit in *Rodman* v. *United States,* 519 F.2d 1058 (1st Cir. 1975), where an indictment was dismissed on account of SEC staff misconduct in recommending criminal prosecution. (A. 41)

The District Court also sustained certain of the petitioners' alternate grounds for dismissal. Analyzing the purpose of the November 1971 TDA prospectus, the court held that the ERD transactions were simply immaterial to the public's purchase of TDA stock pursuant to that prospectus. The government, said the court, could not show how those earlier transactions reflected upon the company's financial status or otherwise. (A. 48-50)

As to the December 1971 TDA proxy statement, the court held that the ERD transactions bore no direct relationship to the business of the prospective annual meeting—no "transaction causation" could be demonstrated. (A. 53)

Finally on the issue of the validity of the criminal reference, the Chief of the U.S. Attorney's Fraud Unit had testified that he "could not remember" a case in two years in which the procedures set forth in the statutes and SEC regulations for criminal references had actually been followed. (A. 21) The District Court, however, declined to upset that now-endemic "informal" system of criminal references made without Commission approval, apparently on the view (later acknowledged by the SEC to be erroneous) that the Commission had sanctioned "informal" references by the staff that have no Commission authorization. (A. 33)

The Court of Appeals

After the government appealed, the Second Circuit requested that the SEC submit an *amicus* brief on the ques-

tion of the validity of the criminal reference made by the SEC staff.

On that issue, Judge Timbers, writing for a majority of the panel, reasoned as follows:

In the case of a formal, private SEC investigation following a Commission *formal* order of investigation, the pertinent statute and regulations do require explicit Commission authorization for a *formal* criminal reference. In the case of an *informal* SEC investigation, the regulations permit the staff to make an *informal* criminal reference without explicit Commission authorization. He purported to find authority for this distinction in a delegation of authority to the staff set forth in passages from an SEC internal manual set out in footnotes to the opinion.* (A. 90-94)

Judge Timbers then stated (contrary to fact, as the court later acknowleged) that the SEC investigation in this case was an *informal* investigation. Since, as he further opined, the SEC staff's delivery of the file—and recommendations of criminal prosecution—were merely an *informal* criminal reference, he held that the reference procedure here employed did not require express Commission approval. Therefore, he reasoned, it was lawful**. (A. 93-94)

Judge Timbers went on to praise the pervasive "informal" criminal reference procedure that had developed between the SEC staff and the U.S. Attorney's Office. Far

* In fact, there is no authority for such a distinction: the SEC internal manual was not "published," and the statute requires that any such delegation be by "published" rule (Add. 3). Moreover, the passages from that manual that immediately follow those quoted in the opinion contain an express proviso excluding such delegation in the case of formal investigations (Add. 7-8).

** In fact, it is now undisputed that even *informal* criminal references require Commission approval. *See infra,* pp. 12-13.

from being unlawful, he said, it was "a commendable example of inter-agency cooperation" (A. 95).

Turning to the issue of the SEC staff's fraudulent conduct, the panel held that the District Court abused its discretion in dismissing the tainted portions of the indictment on account of that misconduct. The majority, although not disturbing any of Judge Haight's findings, ruled that the remedy of dismissal was not warranted because a) the misconduct here was not as "egregious" as that in *Rodman v. United States, supra,* and b) the deception practiced upon petitioners did not "prejudice" them in the criminal case.* (A. 97-98)

The majority then addressed the district court's alternate grounds for dismissing substantial portions of the indictment. Adopting almost *in haec verba* a new theory of materiality first advanced by the government in the Court of Appeals, Judge Timbers reasoned as follows: The *April and May 1971* ERD transactions were "material" to TDA, and thus were required to be disclosed in the *November 1971 TDA* prospectus, because those asserted "kickbacks" to petitioners

> "*may well* be immediately recoverable by TDA, Inc. as a short swing purchase and sale under Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1976)" (A. 102; emphasis added).

(Not even the SEC had claimed in its civil investigation that the alleged ERD "kickbacks" constituted a 16(b) violation.)

The panel adopted a similar rationale to find the ERD transactions "material" to the TDA December 1971 proxy

* Judge Mansfield, in a brief concurring opinion, found the SEC's conduct "deceitful and duplicitous," but he nevertheless concurred in the result because he believed that "no prejudice warranting dismissal of the indictment is shown" (A. 105).

statement. The panel noted first that one of the proxy rules requires disclosure of

> 'indebted[ness] to the issuer . . . [of e]ach director or officer of the issuer . . . [including] any indebtedness . . . [which] arose under Section 16(b) of the [Securities Exchange] Act . . .' (A. 103).

It thereupon reasoned:

> "Defendants' sale of TDA shareholders' lettered stock immediately after acquiring it in a private placement—the ERD kickbacks—clearly would violate Section 16(b). Accordingly, their failure to disclose these kickbacks, if proven, would constitute a violation of Item 7(e)(4) and consequently of Section 14(a)" (A. 103-04).

The Court of Appeals remanded the case with instructions to reinstate the entire indictment. (A. 104)

Rehearing

On petitioners' motion for rehearing, the SEC filed still another *amicus* brief. In that brief, the SEC conceded

a) that the investigation here was a "formal" investigation;

b) that *both* "formal" and "informal" criminal references require approval by the Commission itself;

c) that there was no Commission approval in this case.

On February 14, 1979, the Court denied the petition for rehearing, but adopted *in toto* the position of the SEC in its *amicus* brief. The Court made certain "technical" corrections to its opinion suggested by the SEC, and adopted the SEC position that the staff's conduct here was not a "criminal reference" at all—but amounted merely to "preliminary communications" (A. 109-11).

But neither the amended opinion nor the SEC brief so much as mentioned the fact that the government had *stipulated* in the District Court that the SEC staff here ***had made a "criminal reference"***—and that the parties and the court proceeded on that basis through eleven days of hearings. (Tr. 7-9; A. 20-21, 23)*

Reasons for Granting the Writ

I.

The Second Circuit's Unwarranted, Ominous Expansion of SEC Disclosure Laws Creates a Conflict Among the Circuits.

The Second Circuit committed serious error in its interpretation of the scope of the federal securities laws—error with far-reaching implications for the civil and criminal administration of those laws and error which creates conflict among the circuits.

The Panel's Far-Reaching Error

The Second Circuit panel created a bootstrap definition of "materiality" that required petitioners (a) to draw a legal conclusion they dispute and then, on that basis alone, (b) to "disclose" that legal conclusion, or the facts forming the basis for that conclusion, in SEC filings.

The panel, purporting to rely on this Court's definition of "materiality" in *Northway,*** held that the April and May 1971 ERD transactions were "material" *to TDA* so

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* Petitioners had brought this stipulation to the Court of Appeals' attention long before it corrected its opinion.

** *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976).

as to require disclosure in its November 1971 prospectus because:

> Defendants' $300,000 profit on this transaction, while ultimately coming out of the pockets of the defrauded stockholders, *may well* be immediately recoverable by TDA, Inc. as a short swing purchase and sale under Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1976) (A. 102; emphasis added).

Similarly, with respect to TDA's December 1971 proxy statement, the panel found omission of the ERD "kick-backs" material because the proxy rules require disclosure of an officer's 16(b) "indebtedness" to the issuer. (A. 102-03)

But petitioners dispute as a matter of law that 16(b) even applies to the ERD transactions—much less that they incurred any 16(b) liability, or "indebtedness" to TDA. At the time the 1971 TDA prospectus and proxy statements were filed, no litigation had been commenced asserting that petitioners had committed a 16(b) violation; indeed, to this day, there has been no such litigation (other than the government's *de novo* appellate criminal theory). Even the SEC in its lengthy civil complaint against petitioners made no such claim.

The panel's definition of "material" therefore comes to this: Facts concerning corporate-related conduct by a corporate officer, whether or not significant in a financial sense,* are "material" and are required to be disclosed, if

* The amount involved in the ERD transactions was clearly not "material" to TDA in any recognized financial sense. TDA's assets in 1971 exceeded $18,000,000. *See* Joint Appendix in the Court of Appeals at 135. The speculative potential asset of $300,000 that the panel held "may well" be recoverable constituted 1.6% of TDA's assets. We know of no case or other authority which suggests that such a miniscule percentage of even *hard* assets is material, much less

(footnote continued on following page)

those facts "may well" someday be found by some court to constitute some violation of law—even if, at the time of the pertinent SEC filing, that conduct had never been adjudged or alleged to constitute a violation and even if the officer maintains it constitutes no violation.

As one court put it, "It would be an interesting theory indeed to impose upon a corporation the duty to disclose . . . not yet existent litigation," *Shapiro* v. *Belmont Industries, Inc.*, 438 F. Supp. 284, 292 (E.D. Pa. 1977).

Unfortunately, the Second Circuit here adopted just that "interesting theory" of the disclosure laws. That theory must be wrong.

First, *Northway* made it clear that even *facts* which a reasonable investor "might" consider important are not material because the "might" formulation is "too suggestive of mere possibility." *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976). The panel's formulation here—"may well"—is no more concrete. Indeed, the panel's interpretation of "materiality" would have a corporate officer engage in *two* levels of conjecture—speculating first whether his conduct "might" have violated 16(b) or some other provision of law, and second, whether a reasonable investor "might" find the purported illegal action significant to an investment decision.

Further, in looking to the possible "materiality" of legal conclusions rather than facts, the panel's entire focus is

that such a contingent pre-tax asset is material. (Under generally accepted accounting principles—indeed, the SEC itself insists that—a corporation's recovery under 16(b) is not an income item but a balance sheet item. *See, e.g.*, L. Rappaport, SEC Accounting Practice and Procedure 18.21 (3d Ed. 1972); Montgomery's Auditing 621 (9th Ed. 1975).

In any event, it is clear from the panel's holding as to the proxy statement that the panel was not relying on financial materiality.

wrong. And the panel suggests no limit on the extent to which directors and officers are to divine and disclose the possible—perhaps, remotely conceivable—legal consequences of their actions, upon pain of damage suits or, as here, criminal penalties.

The consequences of the panel's decision for both the civil and criminal administration of the securities laws are portentous.

On the civil side, the panel's rationale threatens to "jigsaw every kind of corporate dispute into the federal courts through the securities acts as they are presently written,"* and to undermine this Court's efforts to disengage the federal judiciary from such disputes.** The plaintiff in the garden-variety derivative suit asserting claims on behalf of the corporation against a director now may obtain federal jurisdiction simply by alleging, in the words of the Second Circuit panel, that the directors failed to disclose in some SEC filing that the corporation "may well immediately recove[r]" for the director's alleged waste, breach of fiduciary duty, or other common law offense.

As to the criminal laws, the panel's decision would make the securities laws an alternative enforcement arm for the entire federal criminal code.

In the panel's word, petitioner's alleged violations here were "kickbacks"—acts which are offenses under the Hobbs Act or the mail fraud provisions. *See, e.g., United States* v. *Phillips*, 577 F.2d 495 (9th Cir. 1978), *cert. denied*, 99 S.

* Cary, *Federalism and the Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974).

** *See, e.g., Green* v. *Santa Fe Industries*, 430 U.S. 462 (1977); *Cort* v. *Ash*, 422 U.S. 66 (1975).

Ct. 154 (1978); *United States* v. *Rabbitt*, 583 F.2d 1014 (8th Cir. 1978).*

But by the time the indictment here was filed—after a delay caused in part by the government's own misconduct in urging prosecutorial delay until the SEC settlement was concluded—the five-year statute on the Hobbs Act or for mail fraud had run. So the prosecutor indicted petitioners for failure to "disclose" that they had committed the underlying offense.

The opinion on which the Second Circuit upheld that indictment, if applied according to its rationale—*i.e.*, there exists a duty to disclose conduct which "may well" have violated the law—would enable a prosecutor to embrace *any* corporate-related federal crime within a securities law disclosure violation. The federal statute of limitations, as applied to corporate executives, would no longer be five years, but an indefinite period extending throughout the executives' tenure as an officer having SEC filing responsibilities. The statute would not even begin to run from the date of the underlying offense—but from the date of the officer's *last* SEC filing.

The Second Circuit's interpretation of the disclosure laws is far too invasive: the panel in effect viewed SEC filings as corporate officers' confessionals—contrary to our most basic notions about self-incrimination. Whether the issue be "materiality" or some other concept, it surely cannot become the law of this nation that an officer is required to advertise in a public filing something he did in the past because it "may well" have violated some law—and if he

* Or, as the District Court noted, those alleged "kickbacks" might constitute 10b-5 violations *vis-a-vis* the selling stockholders. But, as he correctly observed, any such violation "would [also] appear to be barred by the statute of limitations" (A. 49).

fails so to advertise, he can be indicted for the nondisclosure when he could not be indicted for the underlying substantive crime.

We respectfully submit that a decision having such impact upon the civil and criminal law should be reviewed by this Court.

The Conflict

Review is necessary, too, because—not surprisingly—the Second Circuit's bootstrap view of the securities laws as requiring disclosure of speculative conclusions is in conflict with decisions in other circuits—indeed, with decisions in the same circuit.

The Third Circuit has held that there is no requirement to disclose that corporate conduct may be *ultra vires*. *Ash* v. *LFE Corp.*, 525 F.2d 215 (3d Cir. 1975). The Eighth Circuit has held that there is no requirement to "characterize the bonus aspect of the transaction as plaintiff would have it characterized." *Golub* v. *PPD Corp.*, 576 F.2d 759, 765 (8th Cir. 1978).

See also Browning Debenture Holders' Committee v. *DASA Corp.*, 560 F.2d 1078, 1084 (2d Cir. 1977) (no requirement to disclose that corporate conduct may be a violation of state law); *Shapiro* v. *Belmont Industries, Inc.*, 438 F. Supp. 284 (E.D. Pa. 1977); *Freedman* v. *Barrow*, 427 F. Supp. 1129, 1144 (S.D.N.Y. 1976) ("Failure to disclose a legal theory with which those soliciting [proxies] do not agree . . . does not violate" federal disclosure laws); *Robbins* v. *Banner Industries, Inc.*, 285 F. Supp. 758, 762 (S.D.N.Y. 1966) (No requirement to disclose allegedly "fraudulent activity.")

II.

The Court Below Erred in Upholding the SEC Staff's Widespread Abuse of the SEC's Published Rules on Criminal References.

The SEC's latest annual report reveals a recent dramatic increase in the number of criminal referrals to the Justice Department.* At the same time, the lower courts increasingly have been faced with problems arising out of the SEC's exercise of prosecutorial power, particularly in the context of settlement negotiations. *See e.g., Rodman* v. *United States*, 519 F.2d 1058 (1st Cir. 1975); *United States* v. *Merz*, 580 F.2d 342 (8th Cir. 1978); *United States* v. *Minnesota Mining & Manufacturing Co.*, 551 F.2d 1106 (8th Cir. 1977); *United States* v. *Bloom*, 450 F. Supp. 323 (E.D. Pa. 1978); *United States* v. *Dondich*, 460 F. Supp. 849 (N.D. Cal. 1978).

In these circumstances, this Court should review a decision below which is flagrantly erroneous and which sanctions a pervasive disregard of the statutes and regulations on criminal references.

The securities statutes each contain a provision authorizing the *Commission* to transmit evidence concerning alleged violations of law to the Attorney General for criminal prosecution (Add. 2-3).** The language of each statute provides that "[T]he *Commission* may transmit such evidence . . ." *See* 15 U.S.C. § 77(t) (1976); 15 U.S.C. § 78u (1976) (emphasis added). The use of the permissive

* There were 100 such referrals in 1977 and 116 in 1976; in 1968-71 the number ranged from 22 to 40. 43 SEC Ann. Rep. 326 (1977).

** "Commission" is defined to mean the five commissioners. 17 C.F.R. § 200.10 (1978).

"may" gives the Commission the option to make a reference or not; it does not render the form of reference optional.

To be sure, the statutes grant the Commission authority to delegate this responsibility to an employee of the Commission by "published rule or order." 15 U.S.C. § 78d-1(a) (1976) No published rule or order, however, makes any such delegation.

Indeed, not only must every SEC criminal reference have Commission approval, but, recognizing that the power to recommend prosecution is awesome, the Commission regulations require staff review at the highest level:

> ". . . [T]he Director [of the Division of Enforcement] is responsible, in collaboration with the General Counsel, for the review of cases to be referred to the Department of Justice with a recommendation for criminal prosecution." 17 C.F.R. § 200.19(b) (1978)

In this case, there was no Commission approval nor any consultation with the SEC's General Counsel or Director of Division of Enforcement. The Director of the Division of Enforcement testified that before the reference he had never even heard of this case. (Tr. 674) The two SEC staff members here neither informed nor consulted anyone of authority before making what was *stipulated* to be a criminal reference. (Tr. 9)

Initially, the Second Circuit avoided the inevitable conclusion that this reference was unlawful only by a) adopting a factually incorrect premise that the SEC had here conducted only an "informal" investigation, and b) by characterizing the reference as an "informal" reference that thereby somehow made it lawful. Even that distinction was error: nothing in any published rule or regulation permits even "informal" criminal references without Commission approval, as the SEC conceded in its last *amicus* brief.

The panel then compounded its error when it "corrected" its opinion and said, at the SEC's urging, that the reference here was lawful because it wasn't a reference at all—merely "preliminary communications."

We most respectfully submit that such a semantic distinction would be absurd under the facts of this case (which included a call to the prosecutor saying "we want to get" petitioners)—even if there had been no stipulation in the trial court that what occurred *was* a "criminal reference." Given that stipulation, the decision of the panel on this point is utterly indefensible.

In short, the SEC violated its own rules in referring this case for criminal prosecution. And the only appropriate remedy was to void the fruits of that misconduct—in this case, to dismiss the indictment.*

The violation is not an isolated instance. The trial court found that by their "informal" reference, the two SEC staff members here had "followed a practice which had grown up over the past several years" and which in fact "accounts for the majority of present-day criminal references in the Second Circuit" (A. 20-21, 34). *See also United States* v. *Bloom, supra,* 450 F. Supp. at 329. It appears, in short, that the abuse of the SEC's published regulations on criminal references is becoming universal. The Second Circuit, terming that abuse "commendable," clearly will not compel the agency to abide by its rules.

---

* This Court has long recognized the need for regularity and accountability in the administrative process, and has held repeatedly that administrative agencies must scrupulously adhere to the standards they have established for their own conduct. *Yellin* v. *United States,* 374 U.S. 109 (1963); *Vitarelli* v. *Seaton,* 359 U.S. 535 (1959); *Service* v. *Dulles,* 354 U.S. 363 (1957); *United States ex rel. Accardi* v. *Shaughnessey,* 347 U.S. 260 (1954). If an agency deviates from its rules and regulations, any action so taken is void. *Yellin* v. *United States, supra.*

This Court, we submit, should issue the writ in order to do so—and in order to correct the panel's error in reinstating the indictment.

III.

The Decision Below Conflicts With the First Circuit and Unduly Restricts the Supervisory Power of the District Courts to Deal With Government Misconduct.

The Second Circuit held that the District Court was powerless to deal effectively with "the deceitful and duplicitous" conduct of the SEC staff members here. Its unduly narrow construction of the supervisory power stands in stark contrast with that of the Court of Appeals for the First Circuit in *Rodman* v. *United States,* 519 F.2d 1058 (1st Cir. 1975).

In *Rodman,* the First Circuit held that it was not an abuse of discretion for a district court to dismiss an indictment in the interests of the integrity of the judicial process and fairness—where the district court found that the SEC breached an agreement to recommend against criminal prosecution.

The panel in this case sought to distinguish *Rodman* by saying (a) that since *Rodman* involved an express agreement between the SEC staff and defendant, the misconduct in that case was more "egregious;" and (b) that the defendant in *Rodman* was prejudiced by the fact that he had given incriminating evidence in reliance on the agreement.

These distinctions are untenable—and the two cases are hopelessly in conflict.

As to the panel's first purported ground of distinction, it is difficult to comprehend how even as an abstract matter it is morally or legally more "egregious" for the government merely to breach a contract (as in *Rodman*) than fraudulently to induce a contract (as was the case here)— or why the former warrants a broader remedy than the latter. The law has always treated fraud as more reprehensible than breach of contract and has afforded the victim of a fraud broader remedies than the victim of a breach of contract.

Indeed, the facts in *Rodman* were that the SEC staff failed to keep its word because it believed (erroneously, but apparently in good faith) that the defendant had ceased his cooperation and thus failed to meet *his* end of the bargain. 519 F.2d at 1059. There was no finding in *Rodman* of fraud or bad faith on the part of the government. Surely the fraudulent conduct here was more "egregious" than the breach in *Rodman.*

Second, the panel was even more clearly in error when it attempted to distinguish *Rodman* on the ground that Mr. Rodman suffered prejudice in his criminal case, while the petitioners here allegedly did not. The asserted prejudice in *Rodman* was the incriminating testimony given by the defendant to the SEC. But the government had stipulated not to use that testimony in its prosecution of Mr. Rodman. Thus, there was no prejudice to Mr. Rodman—and neither the district judge nor the First Circuit relied upon any showing of prejudice. Nevertheless, the District Court held, and the First Circuit agreed, that dismissal of the indictment was required—out of "fairness".* The same principles of fairness apply here. And the very same grounds existed for the District Court's application of his supervisory power.

The writ should issue to resolve this conflict in the circuits.

* Joint Appendix in the Court of Appeals, at 165 (quoting from the unreported opinion of the Massachusetts District Court).

As between the conflicting views of the two circuits, the Second Circuit's is far too narrow a reading of the supervisory power. Justice Frankfurter observed:

> Insofar as they are used as instrumentalities in the administration of criminal justice, the federal courts have an obligation to set their faces against enforcement of the law by lawless means or means that violate rationally vindicated standards of justice, and to refuse to sustain such methods by effectuating them. They do this in the exercise of a recognized jurisdiction to formulate and apply 'proper standards for the enforcement of the federal criminal law in the federal courts.' *Sherman* v. *United States*, 356 U.S. 369, 380 (1958) (Frankfurter, J. concurring).

And so, where government misconduct is substantial, courts have not hesitated to dismiss an indictment—in the interest of maintaining the integrity of their own processes. *See Dixon* v. *District of Columbia*, 394 F.2d 996, 970 (D.C. Cir. 1968) ("I do not believe we are foreclosed from granting immunity from prosecution in order to deter blatant Government misconduct"); *United States* v. *McLeod*, 385 F.2d 734 (5th Cir. 1967); *United States* v. *Paiva*, 294 F. Supp. 742, 746 (D.D.C. 1969). ("Courts can no more be made the tools of improper administrative conduct than they can become the enforcers of odious agreements").

The Second Circuit panel held that a demonstration of prejudice is necessary before a federal court will intercede to rectify blatant government misconduct.* But that view

* Petitioners, of course, *were* severely prejudiced by the misconduct. Not only was the filing of the indictment itself a very real form of prejudice, but petitioners were deprived of a significant negotiating opportunity—*i.e.*, petitioners could have bargained with the United States Attorney for the sanctions contained in the "civil" settlement. Once petitioners agreed to the SEC settlement, those sanctions were lost to them for any negotiation with the U.S. Attorney.

is inconsistent with the very rationale underlying application of the supervisory power:

> "So long as the 'error' violates the Court's standards for conducting judicial proceedings, reversal will usually follow *even though the effect on the particular litigant may have been inconsequential or non-existent*". Note, *The Supervisory Power of the Federal Courts*, 75 HARV. L. REV. 1656, 1657 (1963) (Emphasis added)

The panel's decision simply ignores what both the decisions of this Court and the scholarly literature have recognized—that the supervisory power is an important and malleable tool in the administration of justice more concerned with the integrity of the judicial process than with whether the misconduct has prejudiced a litigant. *See, e.g., Santobello* v. *New York*, 404 U.S. 257 (1971); Note, *The Judge-Made Supervisory Power of the Federal Courts*, 53 GEO. L.J. 1050 (1965); Note, *Supervisory Power in the United States Courts of Appeals*, 63 CORN. L. REV. 642 (1978); Hill, *The Bill of Rights and the Supervisory Power*, 69 COLUM. L. REV. 181 (1969).

This Court should grant the writ to provide guidance to inferior federal courts in the exercise of this important power.

CONCLUSION

SEC Commissioner Karmel, disturbed (like much of the bar and business community*) about increasing SEC in-

* R. Karmel, Jurisdictional Concerns in Securities Law Enforcement (Feb. 23, 1978). (Address Before the Federal Bar Council) at 12; *See also* Interview with SEC Commissioner Roberta Karmel, [1978] SEC REG. & L. REP. (BNA) No. 467 at AA-1; *The SEC: Going Too Far Too Fast*, BUSINESS WEEK, November 27, 1978, at 86; Klein, *A Response on SEC Consents—'Process Is Corrupting All'*, LEGAL TIMES OF WASH., June 26, 1978, at 21.

trusion into matters outside its jurisdiction, and *dehors* authorized procedures, recently cautioned:

> "The government should not have the power to prosecute its citizens for behavior which has not been declared illegal by the Legislature. And prosecutorial power should be kept within the confines of specified sanctions and procedures."

Government power in this case was exceeded in both these respects.

We ask this Court to grant *certiorari* to review the Court of Appeals' acquiescence in these excesses, and upon such grant, to vacate the Court of Appeals' reinstatement of the indictment.

March 26, 1979

Respectfully submitted,

SIMON H. RIFKIND
345 Park Avenue
New York, New York 10022
(212) 644-8000
Attorney for Petitioner
Douglas P. Fields

Of Counsel:
MAX GITTER
WILLIAM B. POLLARD
PAUL, WEISS, RIFKIND,
WHARTON & GARRISON

NORMAN S. OSTROW
375 Park Avenue
New York, New York 10022
(212) 832-3611
Attorney for Petitioner
Alan S. Sandberg

Of Counsel:
FRANK WRIGHT
GRAND & OSTROW

ADDENDUM

Statutes

Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a) (1976):

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1976):

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

Securities Act of 1933, § 20, 15 U.S.C. § 77t (1976):

Injunctions and prosecution of offenses.

(b) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States or United States court of any Territory, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this subchapter.

Securities Exchange Act of 1934, § 21, 15 U.S.C. § 78u (1976):

Investigations; injunctions and prosecution of offenses.

(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

15 U.S.C. § 78c (1976):

Definitions and application—Definitions.

(15) The term "Commission" means the Securities and Exchange Commission established by section 78d of this title.

* * *

15 U.S.C. § 78d-1 (1976):

Delegation of functions by Commission—Authorization; functions delegable; eligible persons; application of other laws.

(a) In addition to its existing authority, the Securities and Exchange Commission, hereinafter referred to as the "Commission", shall have the authority to delegate, by published order or rule, any of its functions to a division of the Commission, an individual Commissioner, a hearing examiner, or an employee or employee board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter: . . . .

Regulations

17 C.F.R. § 200.10:

The Commission.

The Commission is composed of five members, ... The Commission is assisted by a staff, which includes

lawyers, accountants, engineers, financial security analysts, investigators and examiners, as well as administrative and clerical employees.

17 C.F.R. § 202.5:

Enforcement activities.

(b) Where it appears after investigation or otherwise that there has been a violation of any of the provisions of the acts administered by the Commission or the rules or regulations thereunder, the Commission may take one or more of the following actions: institution of administrative proceedings looking to the imposition of remedial sanctions, initiation of injunction proceedings in the courts, and, in the case of a willful violation, reference of the matter to the Department of Justice for criminal prosecution. The Commission may also on some occasions refer the matter to other Federal agencies, State authorities or organizations such as the stock exchanges or the National Association of Securities Dealers, Inc.

17 C.F.R. § 200.19b:

Director of the Division of Enforcement.

The Director of the Division of Enforcement is responsible to the Commission for the supervision and conduct of all of the enforcement activities under each of the acts administered by the Commission and the investigations relating thereto. The Director is responsible also for the institution of administrative and injunctive actions arising out of such investigations and enforcement activities and for the determination of whether the available evidence supports the allega-

tions in the proposed complaint. In addition, the Director is responsible, in collaboration with the General Counsel, for the review of cases to be referred to the Department of Justice with a recommendation for criminal prosecution.

17 C.F.R. § 200.21:

The General Counsel.

The General Counsel is the chief legal officer of the Commission and is responsible for the representation of the Commission in judicial proceedings in which it is involved as a party or as amicus curiae, directing and supervising all civil litigation in the U.S. District Courts (except District Court proceedings under Chapter X of the Bankruptcy Act), and representing the Commission in all cases in appellate courts. He is responsible, in collaboration with the Division of Enforcement, for review of cases to be referred to the Department of Justice with a recommendation for criminal prosecution.

17 C.F.R. § 230.122:

Nondisclosure of information obtained in the court of examinations and investigations.

Information or documents obtained by officers or employees of the Commission in the course of any examination or investigation pursuant to section 8(e) or 20(a) (48 Stat. 80, 86; 15 U.S.C. 77h(e), 77t(a)) shall, unless made a matter of public record, be deemed confidential. Officers and employees are hereby prohibited from making such confidential information or documents or any other non-public records of the Com-

mission available to anyone other than a member, officer, or employee of the Commission, unless the Commission authorizes the disclosure of such information or the production of such documents as not being contrary to the public interest. Any officer or employee who is served with a subpoena requiring the disclosure of such information or the production of such documents shall appear in court and, unless the authorization described in the preceding sentence shall have been given, shall respectfully decline to disclose the information or produce the documents called for, basing his refusal upon this section. Any officer or employee who is served with such a subpoena shall promptly advise the Commission of the service of such subpoena, the nature of the information or documents sought, and any circumstances which may bear upon the desirability of making available such information or documents.

17 C.F.R. § 240.14a-9 (1978):

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

SEC Manual of Administrative Regulations

Manual Release No. 155-75

1:171.01 9/24/74

Section 171: Cooperation With Federal, State and Foreign Government Authorities and With Self-Regulatory Organizations

171.06

Cooperation With Other Federal Law Enforcement Authorities.

Since Commission cases frequently involve violations of the mail fraud statute and may involve other Federal statutes, the Commission recommends and encourages full cooperation with inspectors of the United States Post Office Department and other Federal law enforcement officials. Commission officials are authorized in their discretion to make information developed in the course of their investigations, other than formal investigations which have been ordered by the Commission, and other non-public information available to these officials and to render such investigative assistance as may be required.

171.07

Furnishing Information to Other State and Federal Law Enforcement Agencies.

In cases not falling within Subsections .05 and .06 of this Section, that is, situations other than referral of a matter for State enforcement action, or cooperation with the Post Office Department or other Federal law

enforcement officials, Commission officials are authorized in their discretion to make available to Federal and State law enforcement to Federal and State law enforcement (sic) agencies information developed in the course of an investigation other than a formal investigation which has been ordered by the Commission and other non-public information when the Commission official is satisfied that such action clearly will not interfere with the Commission's enforcement functions in the particular case or in other cases.

171.08

Disclosure of Information in Formal Investigations.

If a Commission official believes that a formal investigation which has been ordered by the Commission should be referred to Federal or State authorities for enforcement action under the foregoing standards, the Commission official may recommend to the Commission that information be turned over to such authorities.

Supreme Court, U.S.
FILED
MAR 26 1979
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

Nos. 78-1474
78-1480

DOUGLAS P. FIELDS and ALAN E. SANDBERG,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

FREDERICK M. FRIEDMAN,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETER S. DAVIS,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

APPENDIX TO PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

SIMON H. RIFKIND
345 Park Avenue
New York, New York 10022
(212) 644-8000
Attorney for Petitioner Douglas P. Fields

Of Counsel:
MAX GITTER
WILLIAM B. POLLARD
PAUL, WEISS, RIFKIND,
WHARTON & GARRISON

(Additional counsel listed on inside page)

BENDER & FRANKEL
225 Broadway
New York, New York 10007
(212) 227-6000

Attorneys for Petitioner Frederick M. Friedman

Of Counsel:

LOUIS BENDER
SANDOR FRANKEL

GARY P. NAFTALIS
One Rockefeller Plaza
New York, New York 10020
(212) 586-2211

Attorney for Petitioner Peter S. Davis

Of Counsel:

GARY H. GREENBERG
ORANS, ELSEN, POLSTEIN & NAFTALIS

NORMAN S. OSTROW
375 Park Avenue
New York, New York 10022
(212) 832-3611

Attorney for Petitioner Alan E. Sandberg

Of Counsel:

FRANK WRIGHT
GRAND & OSTROW

TABLE OF CONTENTS

PAGE

Appendix A:

Opinion of the United States District Court for the Southern District of New York, dated June 2, 1977 (unreported) 1a

Appendix B:

Opinion on reargument of the United States District Court for the Southern District of New York, dated July 7, 1977 .... 75a

Appendix C:

Opinion of the United States Court of Appeals for the Second Circuit, dated September 14, 1978 (unreported) 79a

Appendix D:

Judgment of the United States Court of Appeals for the Second Circuit, entered September 14, 1978 .... 106a

Appendix E:

Orders of the United States Court of Appeals for the Second Circuit Upon Petition for Rehearing and Suggestion for Rehearing En banc, entered February 14, 1979 .... 108a

APPENDIX A

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

76 Cr. 1022-CSH

UNITED STATES OF AMERICA,

—against—

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG and ERIC BERGE,

Defendants.

MEMORANDUM OPINION

APPEARANCES:

ROBERT B. FISKE, JR.
United States Attorney for the Southern District of New York
One St. Andrew's Plaza
New York, New York 10007
DAVID A. CUTNER, ESQ.,
SARAH S. GOLD, ESQ.,
Assistant United States Attorneys, Of Counsel.

LOUIS BENDER, ESQ.
225 Broadway
New York, New York 10007
Attorney for Douglas P. Fields and Frederick M. Friedman
SANDOR FRANKEL, ESQ.,
Of Counsel.

Gary P. Naftalis, Esq.
One Rockefeller Plaza
New York, New York 10020
Attorney for Peter S. Davis,
Messrs. Orans, Elsen & Polstein,
Of Counsel.

Norman S. Ostrow, Esq.
375 Park Avenue
New York, New York 10022
Attorney for Alan E. Sandberg
Messrs. Grand & Ostrow,
Of Counsel.

John J. Tigue, Esq.
80 Pine Street
New York, New York
Attorney for Eric Berge
Messrs. Kostelanetz & Ritholz,
Of Counsel.

Haight, *District Judge*:

INTRODUCTION

In this memorandum the Court rules upon a number of pre-trial motions put forward by the defendants, some in concert, others individually.

I shall first consider a motion in which all defendants join: to dismiss the indictment on the basis of prior negotiations with Securities and Exchange Commission ("SEC") attorneys, which culminated in the filing of a civil complaint and consent judgments executed by the defendants. Thereafter I shall address the various alternative motions for dismissal or other relief. As a preface, however, the indictment must be summarized.

I.

THE INDICTMENT

Defendants Douglas P. Fields ("Fields"), Frederick M. Friedman ("Friedman") and Alan E. Sandberg ("Sandberg") were officers and/or directors of TDA Industries, Inc. ("TDA"), a publicly-held corporation whose shares were actively traded on the over-the-counter securities market. Defendant Peter S. Davis ("Davis") is an attorney whose law firm was counsel to TDA and defendant Eric Berge ("Berge") was an officer and director of Westcalind Corporation ("Westcalind"), also a publicly-held company whose majority and controlling shareholder was TDA.

In essence, the present indictment charges Fields, Friedman and Davis, in counts one and two, respectively, with conspiring to, and in fact engaging in, illicit schemes and misrepresentations designed to artificially inflate the price of TDA stock prior to a public offering of that company's shares contrary to Section 17 of the Securities Act of 1933, 15 U.S.C. §§ 77q(a) and (x) ("Section 17"). These manipulations are averred to have involved the defendants, or various combinations of them, in other violations of the substantive law, including contravention of the proxy regulations as set forth in Section 14 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78n(a), (ff) ("Section 14") and the rules promulgated thereunder, 17 C.F.R. 240.14a-9 as well as the false statements provision of Title 18, 18 U.S.C. § 1001.

More specifically, it is averred with respect to the conspiracy count that Fields, Friedman and Davis agreed to participate in certain fraudulent transactions for the purpose of boosting the price at which TDA stock would sell on the market at about the time of a November, 1971 public

offering of some 703,943 shares of TDA, which was being made by certain investors in that company. This maneuver is said to have been made necessary because TDA management had guaranteed these shareholders that their stock, when offered on the open market, would command a guaranteed price per share.

In order to facilitate this scheme, two ploys were utilized. First, it is averred that Fields offered one Thomas Zammas ("Zammas") and other unidentified persons cash payments to induce them to make purchases of TDA stock immediately prior to the public offering. Additionally, the indictment charges these individuals with employing a reciprocal stock purchase agreement whereby Zammas and others would purchase, on the open market, four TDA shares for every one share of Mastercraft Medical and Industrial Corporation (a company controlled by Zammas through his substantial stockholdings therein) similarly purchased by Fields. The object of these activities was allegedly to cause the market price of TDA stock to rise and be maintained at an artificially high and inflated price.

Second, the Government contends that the TDA public offering of November 10, 1971 was accompanied by a prospectus prepared by Fields, Friedman and Davis which was materially false and misleading in that it failed to disclose the following:

(1) A March, 1971 payment of $50,000 by Westcalind, at the insistence of Fields and Friedman, to Bernardi Resources Corporation ("Bernardi"), a private investment company, which was styled a "finder's fee" for efforts in connection with certain corporate acquisitions by Westcalind, when in fact no such services were performed and $35,000 of this fee was remitted to Fields and Friedman. This sham was disguised as a legitimate business trans-

action through the back-dating of correspondence between one Stanley Schonbrun ("Schonbrun"), Bernardi's attorney, and Berge. Defendants' counsel have denominated this the "Westcalind kick-back";

(2) A device whereby Enterprise Research & Development Co. ("ERD"), a private investment company, was induced in April, 1971 by Fields, Friedman and Davis to sell 90,000 unlettered shares of TDA to Bernardi at approximately $2. per share below the going open market price for such stock, upon an assurance by TDA that such transfer was a private placement. By prearrangement, however, these shares were immediately registered for public sale, and in fact sold by Bernardi at a substantial profit, 70% of which was kicked back to these defendants. Bernardi's downpayment for the stock was provided by Davis, who in turn had received the money as a loan from White Lamps, Inc., a TDA subsidiary. There is no allegation, however, that this loan was not paid back.

(3) A similarly inspired plan, executed in May, 1971 pursuant to which ERD and a group of fourteen TDA shareholders, possessing in the aggregate 123,178 shares of unlettered TDA stock, were caused to sell to Bernardi their holdings at a price considerably beneath that prevailing for comparable registered TDA stock. Following this transaction, certain TDA officers lifted the restrictions on these shares, which were then sold at a substantial increase in the open market, and 70% of the profits derived therefrom secretly remitted to Fields, Friedman and Davis. The April and May transactions have come to be identified as the "ERD kick-backs".

These machinations, as described in the conspiracy count of the indictment (count one), are averred in count two to be violative of Section 17(a); and as a consequence of filing

the November 10, 1971 prospectus with the Securities and Exchange Commission, Fields, Friedman and Davis are charged in count three with having submitted false statements to Government authorities, contrary to 18 U.S.C. § 1001.

On December 17 and December 23, 1971, proxies were solicited from TDA and Westcalind shareholders, respectively, concerning various corporate matters including the election of officers and directors. As with the November prospectus, it is averred that the proxy materials failed to disclose the activities described above. By virtue of these omissions, count four of the indictment accuses Fields, Friedman and Davis with having contravened Section 14 and the rules promulgated thereunder with respect to the TDA proxy solicitation; and count five charges these individuals, along with Berge, with a similar violation pursuant to the Westcalind proxy material.

Counts six through eleven relate to an entirely different transaction. The Government alleges that Friedman and Sandberg entered into a scheme, at the time of acquisition by TDA of a company called Eagle Roofing and Art Metal Works, pursuant to which Friedman offered a pay-off to one Stuart Kreisler to accept a sham $100,000 "finder's fee" to be paid by TDA, and to kickback $70,000 to Sandberg and an additional amount to Friedman. In connection with this kickback scheme, Friedman and Sandberg are charged with substantive violations of the wire fraud statute, 18 U.S.C. § 1343 (count six) and mail fraud statute, 18 U.S.C. § 1341 (counts seven through ten); and Friedman is charged with proxy act violations in respect of failure to disclose the transaction (count eleven).

Finally, Berge is cited in count twelve of the indictment with having given false statements to the SEC in March, 1975 during that agency's investigation of these dealings. More particularly, the indictment recites that Berge repeatedly testified as to the authenticity of certain correspondence which he knew to have been back-dated so as to disguise the Westcalind kickback as a legitimate "finder's fee".

II.

THE MOTION TO DISMISS THE INDICTMENTS ON THE BASIS OF THE SEC NEGOTIATIONS

As noted, all defendants move to dismiss the indictment on the basis of their prior negotiations with the SEC, culminating in consent judgments which terminated the agency's civil suit against them. It was clear from the motion papers that an evidentiary hearing was necessary to develop the full circumstances. That hearing commenced on April 18, 1977 and was concluded on May 4. The Court heard testimony from two of the defendants, Fields and Davis; their former attorneys; other attorneys representing other defendants; and from representatives of the SEC and the office of the United States Attorney for this district. On the basis of that testimony and related exhibits, the Court makes the following findings.

FINDINGS OF FACT

1. The indictment in this case was filed on November 8, 1976. The charges leveled against the defendants have been summarized *supra.*

2. At the pertinent times, TDA was a New York corporation, whose common stock was registered with the SEC pursuant to the securities laws, and was traded in the over-the-counter market.

3. At the pertinent times, Westcalind was a Delaware corporation, whose common stock was registered with the SEC, and was traded in the over-the-counter market. As of September 8, 1974, TDA controlled a majority of the then issued and outstanding common stock of Westcalind.

4. Defendant Fields had been president of TDA since July 1969, and chairman of the TDA board of directors since May 1970. Fields was president of Westcalind from May 1970 through April 1972, and became chairman of the Westcalind board of directors in May of 1970.

5. Defendant Friedman, a certified public accountant, became financial vice-president, secretary and treasurer of TDA in August of 1970, and became a director of TDA in March 1971. At the pertinent times, Friedman was also the treasurer of Westcalind and a director of that corporation.

6. At the pertinent times, defendant Davis was an attorney and a member of the firm of Davis, O'Sullivan, Weil & Wolff. The Davis firm served as general counsel to TDA from January 1970 to October 1974. Davis was secretary of Westcalind from May 1971 to January 1975, and a director of Westcalind from August 1970 to January 1975.

7. At the pertinent times, defendant Berge was executive vice-president and director of Westcalind.

8. Defendant Sandberg had been vice-president and a director of TDA from October 1966 to May 1970, and a director of Westcalind from September 1970 to March 1972.[1]

[1] The facts set forth in paragraphs 2-8 of these Findings are derived from the SEC civil complaint, GX19 on the hearing. So far as the Court is aware, they are not disputed.

9. In 1974 and extending into January of 1975, the office of the District Attorney, New York County, was conducting an investigation into certain activities of Fields, Friedman and Davis. Those activities related to the purchase and resale of TDA stock. The District Attorney's office was also inquiring into certain finder's fee transactions, and was considering the possibility of prosecution under state income tax laws. Fields, Friedman and Davis were represented, during the District Attorney's inquiry, by the firm of Shea, Gould, Climenko and Casey. Milton S. Gould was the partner in charge of the matter, assisted by his partner Saul S. Streit, a former New York Supreme Court justice. During the course of the District Attorney's inquiry, Gould and Streit concluded that TDA required separate representation. Herbert C. Kantor, a member of the firm of Kantor, Shaw and Davidoff, which was general counsel to TDA, undertook that function.

10. On January 9, 1975, Gould and Streit were advised by Assistant District Attorney Driscoll that his office had concluded that the transactions in question were not cognizable offenses under state law.

11. Gould was quite certain that the District Attorney's office would refer the matter to the SEC's New York regional office. Accordingly he recommended to Fields, Friedman and Davis that it would be preferable for them to bring the matter to the SEC's attention first. Gould regarded such a procedure as highly desirable "if one wanted to avoid a criminal prosecution in this case" under federal securities laws. Gould conferred with Fields, Friedman and Davis on January 10, 1975, and obtained their authority to make certain disclosures to the SEC. On that day Gould telephoned William Moran, regional administrator of the SEC in New York, to ask for an appointment, which was fixed for January 14.

12. Kantor, representing TDA, had agreed with Gould's evaluation, and obtained the approval of the TDA board to cooperate in the disclosures to the SEC.

13. On January 14 a meeting took place at the SEC's New York regional office. Gould and Kantor attended, Gould representing Fields, Friedman and Davis, and Kantor representing TDA. The SEC representatives were: William Moran, the regional administrator; Donald Malawsky, the associate regional administrator; Jeffrey Tucker, a branch chief under Malawsky; William Nortman, an assistant regional administrator; and Stuart Perlmutter, a staff attorney. These SEC representatives had assembled in response to Gould's prior telephone call to Moran, in which Gould said he had disclosures of a serious nature to make. The SEC representatives had no prior knowledge of what Gould was going to say.

14. At the January 14 meeting, Gould and Kantor made the SEC representatives aware of the following transactions, which for the sake of ready reference are keyed to the relevant pages of the indictment:

(1) The transactions in April and May, 1971, pursuant to which ERD was induced to sell 90,000 unlettered shares to Bernardi, who then kicked back 70% of the gross profits on the resale to Fields, Friedman and Davis. [Indictment, Count One, pp. 4-7, ¶¶ 10(f), (g), (h)].

(2) The Westcalind sham finder's fee and kickback, in March of 1971. [Indictment, Count One, p. 4, ¶ 10(e)].

(3) The TDA sham finder's fee and kickback, in 1972 and 1973. [Indictment, Count Six, pp. 12-13, ¶¶ 20-21].

15. At the January 14 meeting, Gould and Kantor did not disclose to the SEC the manipulations of TDA stock

in November, 1971 alleged in the indictment at Count One, p. 3, ¶ 10(a)-(c). Counsel for the defendants said nothing to the SEC about such transactions because the defendants had said nothing on the subject to counsel. This non-disclosure by defendants continued throughout the course of the SEC negotiations. The fact of that non-disclosure is not in dispute, although its consequences are.

16. Gould's objective, in making a voluntary disclosure to the SEC, was to put together a "package", pursuant to which restitution and other civil sanctions might be imposed, but the SEC would not make a criminal reference of the case to the Department of Justice. In Gould's experience, certain factors were significant "in trying to persuade an agency like the SEC, the enforcement people at the SEC that there should be no criminal prosecution" (Tr. 20); he professed to see such factors in the case at bar. There is a conflict in the testimony as to the specificity with which Gould declared his objective to the SEC representatives. Gould testified that he said:

> "... my objective here is to avoid a criminal prosecution and I think if we can use that as coinage in the case, maybe we could make the stockholders whole, maybe we can get back the money that was taken or whatever profits they make coming to the stockholders. I think that is the way I phrased it. I don't remember what my words were, but certainly I was very frank with Mr. Moran and his people as to why we were doing what we were doing." Tr. 31.

The SEC witnesses deny that Gould or Kantor put forward a proposed package that included an understanding that there be no criminal reference. I need not resolve all aspects of this conflict, which may arise in substantial part from semantics and different shadings of inflection. I do

find that, whatever phrases Gould may have used at the initial January 14 meeting or thereafter, Tucker, who was in charge of the SEC's ensuing investigation, was fully aware that defendants' counsel had as one of their two primary objectives the avoidance of a criminal reference, the other primary objective being the retention of Fields and Friedman as officers of TDA. Tucker developed that awareness at the initial January 14 meeting, and it remained in his mind, undiminished, throughout the ensuing events to be related in these Findings.

17. Gould proposed at the January 14 meeting that the SEC investigate the matters disclosed by him, and that, if no further matters of concern were discovered in the inquiry, negotiations take place looking toward a civil settlement. Moran stated that he would first have to obtain approval from the SEC's Division of Enforcement in Washington for the New York office to conduct such an investigation.

18. On February 19, 1975, the SEC approved the Division of Enforcement's recommendation that the New York office be authorized to undertake a formal investigation of the matters disclosed by Gould and Kantor on January 14.

19. On February 28, 1975 a further meeting was held at the SEC's New York office. The participants were Gould; Kantor; Saul S. Streit, a former New York State judge and now a law partner of Gould's; Tucker; and Perlmutter. Gould again made clear to the SEC representatives that one of his primary concerns was to avoid a criminal reference in respect of his individual clients (Fields, Friedman and Davis). Gould also advised Tucker and Perlmutter, at this meeting, that his clients would exercise their Fifth Amendment privilege not to testify during the SEC's in-

vestigation. Subsequently, at the SEC's request, Gould confirmed that position in writing; and none of these individuals were actually summoned to testify before the SEC.

20. The SEC inquiry into TDA, its affiliates and principal officers went forward. Kantor, with the approval of the TDA directors, furnished corporate documents. Certain witnesses testified, as will appear *infra.* Tucker, although reporting to his superiors at the New York regional office, was in operational command of the inquiry. Perlmutter was his top assistant. Various other SEC staff attorneys and investigators were involved.

21. On June 17, 1975, in separate telephone conversations, Tucker advised Gould and Kantor that the SEC investigation was almost concluded; and that it appeared that the January 14 disclosures had been substantially complete and accurate. This advice encouraged defense counsel in their hopes that the matter might be fully resolved through the vehicle of a civil complaint and settlement.

22. While there had been numerous contacts between defense and SEC counsel during the period between February and June, those contacts trailed off after the June 17 conversations referred to in the previous Finding. However, on September 4 the Division of Enforcement in Washington formally authorized the New York office to file a civil complaint and negotiate a settlement. In anticipation of that authority, Tucker had arranged a meeting on September 4 between himself, Perlmutter, Gould and Kantor.

23. At the September 4 meeting, Tucker advised defense counsel of the New York office's authority, and discussed certain details of what the SEC would demand in

its complaint. Specifically, Tucker told Gould that the SEC wanted to obtain broad injunctive relief, disgorgement of any and all monies improperly obtained as a result of defendants' wrongful conduct, removal of Fields and Friedman as directors and officers of the company, installation of a receiver, a restructuring of the board of directors to provide for independent directors, a freeze on the voting of the shares held by Fields and Friedman, and a resignation by Davis of his right to practice before the Commission under Rule of Practice 2(e).

24. Tucker and Perlmutter testified that, at the September 4 meeting, Tucker also said to Gould: "There is no deal on criminal"; and that Gould signified his understanding. Gould and Kantor, while not professing to recall the details of every conversation, were vehement in their testimony that the SEC attorneys never said to them, on September 4 or any other time, that there was "no deal on criminal". It is defendants' contention that, throughout these discussions, SEC counsel remained silent in the face of defense counsel's expressed objective to avoid a criminal reference; and that defense counsel relied on such silence as assent, thus characterizing it to their clients. On the precise point at issue, I do not accept the testimony of Tucker and Perlmutter that such a remark was made at the September 4 meeting. This is the only occasion upon which the SEC attorneys claim to have given an express disclaimer; and yet there were many occasions, both prior and subsequent to September 4, when such a disclaimer would have been equally, if not more, appropriate. As will appear *infra,* Gould and his partner Streit based their post-September 4 reports and counselings to defendants on the assumption that the SEC's continued silence on the subject of a criminal reference was an encouraging sign.

They would not have steered that course if Gould had received an express disclaimer on September 4, unless Gould was prepared to deceive his partner and his clients, a finding I decline to make. Conscious of the difficulties in resolving credibility issues between witnesses who are all members of the bar, I nevertheless reject the Government's evidence on the precise point at issue. In the view I take of the case, however, this Finding is not of decisive significance.

25. On September 11, 1975, Gould had a telephone conversation with Tucker and Perlmutter, in which they advised him of the specific amount of money the SEC would ask the defendants to pay TDA in the complaint to be filed, and other specific relief the SEC intended to demand. On or about that same date, Gould, Kantor, and Streit reported to Fields, Friedman, and Davis their recent conversations with the SEC attorneys. They advised their clients of the sections of the United States Code under which they would be sued, the amount of money that the SEC would sue for, and the specifics of other ancillary relief the SEC would demand in the complaint. Gould recommended that Fields and Friedman authorize him to negotiate a settlement of the dollar amount to a maximum ceiling of \$250,000.00, to be paid by Fields, Friedman and Davis. Fields and Friedman resisted this figure, and also resisted other aspects of the proposed SEC complaint. Gould stated in response to their resistance that if Fields and Friedman did not authorize him to attempt to settle the case on the terms recommended by Gould, then the SEC would not be bound by the agreement which, in Gould's expressed view, it had made with them not to make a criminal reference. Based upon this statement by Gould, Fields and Friedman authorized Gould to attempt to nego-

tiate a settlement in which the maximum amount to be paid would be $250,000.00, and also authorized Gould to make other concessions regarding the ancillary relief that the SEC intended to seek.

26. On September 16 the SEC filed its civil complaint in this court (75 Civil 4519-LWP). Defendants contend that such filing breached the SEC's agreement, reached in a September 11 telephone conversation between Gould, Tucker and Perlmutter, that filing of the complaint would be deferred until a consent had been negotiated which could then be filed with the complaint. Considerable evidence was adduced on this alleged breach of agreement, which the SEC disputes. I do not find it necessary to resolve the conflict on the point. It is evident that when the complaint was filed on September 16 Gould was angry, and upbraided Perlmutter on the telephone. Perlmutter, upset at the incident, reported it immediately to Moran.

27. Shortly after the filing of the SEC's complaint, Gould became seriously ill and was hospitalized, and his partner Streit assumed the rule (sic) of chief counsel for Fields, Friedman and Davis. On September 30, 1975, a meeting was held at the SEC's New York office. Present were Streit and Tucker, Perlmutter, Kantor, and a Mr. Goldman, one of the SEC's investigators. Tucker stated to Streit that the SEC now insisted on Fields, Friedman, and Davis paying $585,000.00 to TDA as part of the settlement. According to his testimony, Streit responded that it was a "horrendous" amount, and there were serious questions concerning some of the figures, "but in light of the fact that there is to be no criminal prosecution I shall endeavor to obtain the money for you" (Tr. 150-153). I accept Streit's testimony that he made a remark of such

substance to SEC counsel at the September 30 meeting. It accords with the impression Streit had received as a result of his discussions with Gould. I further find, in accordance with Gould's testimony, that Tucker and Perlmutter remained silent in the face of Streit's comment.

28. Streit reported this meeting to Fields, Friedman and Davis, including the above-quoted statement that had been made by Judge Streit to which the SEC representatives had not responded. For several months thereafter, Fields and Friedman had a series of meetings with Streit, Gould, and Kantor, as did those attorneys with Davis. Fields, Friedman and Davis resisted the terms that the SEC was demanding for settlement of the civil case. However, their resistance was overcome by their attorneys' advice to them that the SEC had agreed that if a satisfactory settlement was made of the civil action, there would be no criminal reference.

29. In October of 1975, Fields met with an attorney named C. Leonard Gordon. Gordon testified that Fields told him of the SEC's investigation and complaint, and stated that a consent judgment had been agreed to in principle. Fields said that among the elements of relief sought in the SEC's complaint, and demanded by the SEC in the settlement negotiations, was a restructuring of TDA's Board of Directors, and that one element of this restructuring was the addition to the Board of a number of outside "independent" directors. Gordon suggested that one of his clients, one John Mosler, would be an appropriate candidate for one of the new directorships. However, Gordon said that Mosler could not consider serving as a director of TDA unless he was assured that there would be no criminal prosecution following entry of the consent judgments. Fields told Gordon that as part of the settle-

ment agreement the SEC had agreed not to make a criminal reference. Gordon then spoke with Kantor, who verified this statement of Fields. In order to be certain, however, Gordon had his law partner, David Butowsky, former chief enforcement attorney at the SEC in Washington, D.C., call Tucker and arrange for a meeting at the SEC at which Gordon and Butowsky met with Perlmutter. Gordon advised Perlmutter that he represented Mosler, and stated to Perlmutter, among other things, that in deciding whether to accept a directorship in TDA it was important for Mosler to know whether there was going to be a criminal reference of the case. Gordon further stated to Perlmutter that Gordon understood there was not going to be a criminal reference. Perlmutter assured Gordon that there was not going to be a criminal reference. Gordon thereafter reported Perlmutter's assurance to Mosler and to Fields.

30. On October 20, 1975, Kantor, Streit, and Norman Ostrow (counsel for defendant Sandberg) met at the SEC with Tucker, Perlmutter, and possibly Goldman. Tucker advised defense counsel that the SEC would agree to allowing Fields and Friedman to remain as officers of TDA and Westcalind so long as a senior officer was appointed. After some discussion, agreement was reached on most of the terms of the settlement with Fields, Friedman and Davis, except for the matter of collateral to secure the disgorgement, which was to be made over a period of thirty months.

31. Prior to the October 20 meeting, Ostrow had been told by Gould, Kantor and Judge Streit of the SEC's agreement not to make a criminal reference, and that the SEC's agreement not to make a criminal reference also applied to Sandberg. Ostrow attempted to persuade Tucker and Perlmutter, at the meeting in late October, either not to pursue the complaint against Sandberg or to limit the language of the injunction against Sandberg, who had been named in only one of the finder's fee transactions. When Tucker and Perlmutter indicated they were not persuaded, Ostrow agreed to recommend that Sandberg enter into a settlement, stating that settling would be "better than going over to the golden dome", a reference to the United States Courthouse across the street from and visible from the window of the SEC's office. Ostrow's reference to "going over to the golden dome" was intended by Ostrow to be a reference to facing a federal indictment. Under the circumstances, it was undoubtedly so understood by Tucker and Perlmutter, who chuckled at the statement but said nothing.

32. Concurrently with these events, the SEC negotiators had been in communication with the United States Attorney's office on the subject of a criminal reference of the TDA matter. In the early fall of 1975, Perlmutter and Tucker discussed referring the case to the United States Attorney, Tucker stating that he would talk about it to Ike Sorkin, a former SEC staff attorney now serving as an Assistant United States Attorney in the Securities Fraud Unit. On September 16, after the civil complaint was filed in circumstances which prompted Gould to upbraid Perlmutter (see Finding of Fact 26 supra), Perlmutter telephoned Sorkin to urge that the United States Attorney's office "invesitgate the TDA matter." Perlmutter stated that "we really want to get TDA", but advised Sorkin that he first wanted to "wrap up" the civil settlement before the United States Attorney began its own inquiry. Perlmutter made several other calls to Sorkin, of similar import, during October and November, reiterating that the SEC had "a terrific fraud case—the TDA case" which it wanted eventually to send over to the United States Attorney's office. During this stage of the game Sorkin could do no more

than express prospective professional interest, since Perlmutter made it plain to Sorkin that the SEC wished to conclude the civil settlement before the United States Attorney took any action.

33. On December 1, 1975, Gould and Streit met at the SEC with Tucker and Perlmutter. The proposed civil settlement was still being negotiated, with particular reference to the manner in which the defendants' future obligations under the consent judgment were to be collateralized. At the conclusion of the December 1 meeting Gould said to the SEC attorneys: "You've got a great settlement, take it." The defendants' counsel then left. Tucker went directly to the office of Malawsky, his superior, and told him that it looked as if the SEC had a settlement in the TDA case. While Tucker was in Malawsky's office, the latter received a telephone call on an unrelated matter from John Wing, Chief of the Securities Fraud Unit in the United States Attorney's office. Tucker, getting on the telephone, took advantage of the occasion to refer the TDA matter to the United States Attorney for investigation. Tucker followed up that telephone call with a letter to Wing dated December 1, enclosing the SEC's pleadings file on the TDA case and an unrelated matter. The United States Attorney's office declined to proceed on the unrelated matter. In respect of TDA, however, an inquiry was begun, a grand jury presentment made, and the present indictment returned.

34. In making this informal criminal reference to Wing, Tucker followed a practice which had grown up over the past several years. Pertinent statutes and regulations provide for criminal references of matters by the SEC Commissioners themselves to the Department of Justice for possible prosecution. Various administrative steps accom-

pany this procedure. I find, on the basis of Wing's testimony and that of Stanley Sporkin, Chief of the SEC's Division of Enforcement, that in recent years a more informal method of criminal referral has developed, pursuant to which members of SEC regional offices speak directly to the United States Attorneys' offices, and make them aware of cases for possible prosecution. This informal procedure apparently accounts for the majority of present-day criminal references; Wing, chief of the unit concerned in the office of the United States Attorney for this district, stated that he could not remember a case where a formal criminal reference had been made in the last two years.

35. At the time he made the criminal reference of the TDA case, Tucker knew that avoidance of a criminal reference was one of two primary objectives for Fields and Friedman in the civil settlement negotiations (the other being their retention as corporate officers), and the only objective for Davis, an attorney who was not an officer (see Finding of Fact 16 *supra*). Notwithstanding that knowledge, Tucker at no time disclosed to counsel for these defendants that a criminal reference had in fact been made. That non-disclosure was calculated and deliberate, not inadvertent. Tucker testified that he did not want to do anything that would jeopardize the civil settlement (Tr. 1028-1029); and that, in his view, the defendants:

> ". . . believed that there would be no criminal case growing out of this and that is why they entered into a consent decree." (Tr. 1091).

36. On December 10, 1975, Fields and Friedman signed consents to a civil judgment which their counsel then forwarded to the SEC. On December 11 Davis signed a consent to judgment. Defendants Sandberg and Berge also

signed consents to civil judgments, all of which were forwarded to the SEC, and the contemplated judgments were filed in court. The full terms and sanctions imposed by the consent judgments are set forth in the footnote.[2]

[2] Fields, Friedman, Davis, Sandberg, Berge, TDA, and Westcalind—the defendants in the civil action which the SEC had commenced on September 16, 1975—all consented to the entry of judgments against them. The various consents provided for the following relief which the SEC had demanded in its complaint:

(a) The SEC's complaint sought broad injunctive relief against the seven defendants in the civil action; all of the defendants consented to the injunctive relief which the SEC had demanded;

(b) In connection with the ERD transactions, the SEC's complaint sought payment of $435,000.00 by Fields, Friedman, and Davis to TDA, which was the total amount of the alleged profits derived by all parties (not merely Fields, Friedman, and Davis) to these transactions. In their consents, Fields, Friedman, and Davis agreed to pay that entire amount to TDA, and fully collateralized that amount, although the SEC's own investigation revealed that the total amount received by these defendants from the ERD transactions was only $72,250.00, and the defendants were still subject to civil lawsuits from the original sellers of the securities involved in the ERD transactions;

(c) In connection with the Eagle Roofing finder's fee, the SEC's complaint sought payment of $100,000.00 by Fields and Friedman to TDA, which was the total amount of the allegedly unlawful finder's fee. In their consents, Fields and Friedman agreed to pay that entire amount, which they fully collateralized although the SEC's own investigation revealed that $18,000.00 of that amount had never been received by any of the defendants;

(d) In connection with the Trophies, Inc. finder's fee, the SEC's complaint sought payment of $50,000.00 by Fields and Friedman, to Westcalind, which was the total amount of the allegedly unlawful finder's fee. In their consents, Fields and Friedman agreed to pay that entire amount, which they fully collateralized, although the SEC's own investigation revealed that $15,000.00 of that amount had never been received by any of the defendants;

(footnote continued on following page)

Davis also, on December 11, signed a letter constituting a lifetime resignation from practice before the SEC. SEC practice had been Davis' primary activity. Shortly after execution of the consent Davis withdrew from his firm, and has not practiced law to any substantial degree since.

37. I find, on the basis of Gould's testimony, that had he known, subsequent to December 1 but before execution of the consents to judgment, that a criminal reference had in fact been made, he would have recommended to his clients that they not enter into the consents. I further find that such advice would have been accepted, so that the SEC

(e) The SEC's complaint sought an order prohibiting Fields and Friedman and Berge from acting as either officer or director of TDA or Westcalind; the consent judgments prohibited Fields, Friedman and Berge for a two-year period from serving as director of TDA or Westcalind, and, further, from serving as chief executive officer of either company for a two-year period. However, Fields was permitted to remain president, in which capacity he would be chief operating officer, and Friedman was permitted to retain his positions as well;

(f) The SEC complaint sought an order prohibiting Fields and Friedman from voting their shares of TDA and Westcalind stock for a "just and proper" period of time; Fields and Friedman consented to such a prohibition for a two-year period;

(g) The SEC complaint sought an order appointing a receiver for TDA and Westcalind; the consents implemented this request to the SEC's satisfaction by providing for the appointment of independent directors for TDA and Westcalind, as well as Fields' and Friedman's resignations from both boards of directors and the appointment of new chief executive officers for both corporations;

(h) Defendant Davis consented to the most severe administrative sanction available to the SEC, a lifetime resignation from practice before the SEC, as a result of which Davis was forced to resign from the law firm he had built up, which specialized in SEC practice, and was forced to give up the practice of law;

(i) Defendant Sandberg consented in all respects to all relief which the SEC complaint had sought against him, as did defendant Berge.

would have lost the civil settlement which Tucker's concealment of the criminal reference was specifically designed to protect. The SEC negotiators testified that, even if disclosure of the criminal reference had been made, the defendants would have had no option but to agree to the civil settlement. I reject that contention on the facts, and also conclude that, in the circumstances of the case, the SEC is estopped from making it.

38. Defendant Sandberg was represented in the civil settlement negotiations by Ostrow. Ostrow conferred with Gould, Streit and Kantor concerning the substance of the latter's discussions with the SEC; Ostrow also participated in discussions, on Sandberg's behalf, with Tucker and Perlmutter (see Findings of Fact 30 and 31 *supra*). The SEC did not tell Ostrow that a criminal reference had been made on December 1. As a matter of probabilities, I find that if such disclosure had been made, Ostrow would have advised Sandberg not to agree to the consent judgment, and that Sandberg would have accepted that advice. Sandberg executed his consent on January 6, 1976.

39. Defendant Berge, resident in California, was represented by Kantor in respect of the SEC investigation and the civil settlement. As noted *supra*, the SEC did not tell Kantor that a criminal reference had been made on December 1. As a matter of probabilities, I find that if such disclosure had been made, Kantor would have advised Berge not to agree to the consent judgment, and that Berge would have accepted that advice. Berge executed his consent on February 10, 1976.

40. On March 18, 1975, Berge waived his Fifth Amendment privilege and testified before the SEC concerning the Westcalind finder's fee kickback (see p. 4 *supra*). Count

twelve of the indictment charges Berge with having given false statements to the SEC in response to those questions. No reference to the alleged false statements appears in the civil complaint or the consents which terminated the civil litigation.

41. In connection with its inquiry into TDA, the SEC developed some information concerning the alleged manipulations of TDA stock by Fields in November of 1971. As noted in Finding of Fact 15 *supra*, these transactions were not disclosed by any defendant to defense counsel, and thus were not disclosed by defense counsel to the SEC. At the time of its inquiry the SEC concluded that there was insufficient evidence to support a complaint concerning these transactions. However, following the criminal reference the United States Attorney's office pursued the matter further, and the alleged manipulations are now charged in the indictment, at paragraphs 10(a), (b) and (c). The Government stipulated on oral argument that only Fields is involved in these particular transactions.

CONCLUSIONS OF LAW

Discussion

It is by now well settled that prior conduct of government agents may affect the subsequent course of a criminal case. Thus promises given by prosecutors to induce guilty pleas may, if unfulfilled, require vacatur of the plea,[3] resentencing,[4] or even, where equitable considerations require,

[3] *Santobello* v. *New York,* 404 U.S. 257 (1971).

[4] *United States* v. *Brown,* 500 F.2d 375 (4th Cir. 1974); *United States* v. *Ewing,* 480 F.2d 1141 (5th Cir. 1973).

an outright release from custody.[5] Equitable relief is available even where the prosecutor's promises were unfulfillable or he lacked personal authority to make them.[6] Other governmental conduct, arising at an earlier stage in the criminal process, may bar prosecution of an indictment.[7]

Defendants' present motions raise the question of whether the Court should intervene as the result of acts of commission and omission on the part of SEC staff attorneys who handled the matter prior to its reference to the United States Attorney. Defendants contend that the SEC representatives breached an agreement, behaved improperly, and the indictment must be dismissed in consequence. The Government denies any agreement or wrong-going (sic) on the part of the SEC, challenges the good faith of the defendants, and urges trial of the indictment.

In large part, the Court's evaluation of the effect, if any, of prior governmental acts upon criminal proceedings involves application of common sense standards. Thus in *United States* v. *Minnesota Mining & Mfg. Co., supra* n. 7, the court tested for the presence of an alleged government promise that defendant's prior plea would be dispositive of all criminal liability by considering whether:

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[5] *Palermo* v. *Warden, Green Haven State Prison,* 545 F.2d 286 (2d Cir. 1976).

[6] *Palermo,* n. 5 *supra,* at 545 F.2d 296; *Correale* v. *United States,* 479 F.2d 944 (1st Cir. 1973); *United States* v. *Carter,* 454 F.2d 426 (4th Cir. 1972) (*en banc*), *cert den.,* 417 U.S. 933.

[7] *United States* v. *Rodman,* 519 F.2d 1058 (1st Cir. 1975); *United States* v. *Paiva,* 294 F.Supp. 742 (D.D.C. 1969); *United States* v. *Carter,* n. 4 *supra; United States* v. *Pollock,* 417 F.Supp. 1332, 1342 (D.Mass. 1976); cf. *In the Matter of Doe,* 410 F.Supp. 1163 (E.D. Mich. 1976); *United States* v. *Minnesota Mining & Manufacturing Co.,* No. 3-75 Cr. 21 (D.Minn. 1976). The Second Circuit recognizes the supervisory responsibility of the courts to foreclose prosecution of an indictment if tainted by unfair governmental conduct. *United States* v. *Jacobs,* 547 F.2d 772 (2d Cir. 1976).

> ". . . [T]he totality of the conduct and circumstances, viewed objectively, would lead one in the position of the defendants to reasonably conclude that the guilty pleas and full cooperation would be fully dispositive of all criminal matters arising out of the illegal political contributions." Slip Op. at 7.

This approach has equal validity in resolution of the present defendants' motion to dismiss the indictment. The Court must consider the totality of the conduct of the SEC staff attorneys, the defendants, and their attorneys; weigh the reasonable conclusions that the actors might have drawn from such conduct; hold all parties to a standard of fair dealing; and, within that context, decide whether defendants have just cause for dismissal of the indictment.

I consider first defendants' contention that they had an agreement with the SEC, binding on the Department of Justice, that no criminal reference (and hence no criminal prosecution) would take place.

Surely there was no *express* agreement, as to any of the present defendants. They may be contrasted with the cases of Kreisler and Weston, two individuals on the periphery of the transactions in question. Their counsel obtained, in consideration of their testimony to the SEC, specific assurances by the SEC attorneys that they would recommend that neither Kreisler nor Weston be named in the civil action *or* in any criminal reference which might arise out of the pertinent transactions.[8] No such

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[8] Kreisler and Weston were businessmen and acquaintances of Friedman. They were involved on the periphery of certain of the violative acts in question. The SEC regarded their testimony as vital to its inquiry, particularly since the principal actors declined to testify. Following negotiations with counsel for these two individuals, and in accordance with an express agreement reached with counsel, the SEC's New York office recommended to the Division of Enforcement that neither Kreisler nor Weston be named in a civil or criminal action. The Division of Enforcement approved the recommendation.

express assurance was given to the present defendants; they do not really contend otherwise. The case at bar is, in consequence, distinguishable from *United States* v. *Rodman,* 519 F.2d 1058 (1st Cir. 1975), upon which defendants rely. In *Rodman* the district court found that "defendant Rodman was induced to give statements to the SEC upon representations that Mr. Riccio [the SEC staff attorney] would make a recommendation that he not be indicted . . ." 519 F.2d at p. 1059 (material in brackets supplied). No such finding is possible in the instant case with regard to the present defendants. Thus the holding in *Rodman,* dismissing the indictment because the SEC failed to comply with an express agreement, is not apposite here. The same is true of *United States* v. *Paiva,* 294 F.Supp. 742 (D.D.C. 1969), in which the court found (and enforced) an express agreement by the United States Attorney not to prosecute the defendant if he cooperated. *United States* v. *Carter,* 454 F.2d 426 (4th Cir. 1972), which the present defendants also stress, contains broad language, but its holding is limited to a direction that the district court hold an evidentiary hearing to determine "if a promise was made and, if so, by whom and of what scope." 454 F.2d at p. 427 (defendant argued that an assistant United States Attorney had promised freedom from prosecution in exchange for cooperation). In the case at bar, the evidentiary hearing has been held.

Defendants argue, however, that the absence of an express agreement is not fatal to their contract theory. It is said that the SEC's silence, in the face of defense counsel's known desire to avoid a criminal reference, constitutes an acceptance of the proposed package. Defendants point to an indication in a footnote in *Carter, supra,* that the alleged agreement with the prosecutor was based only on

defense counsel's "understanding". 454 F.2d at p. 427 n. 1. Defendants also cite a number of cases involving contracts between private parties, where in certain circumstances silence was held to constitute assent.

I have found that the SEC staff members did not respond specifically to the objective of defense counsel, expressed or understood, that there be no criminal reference. However, it does not follow that such silence, *without more,* gives rise to a binding assent which bars subsequent prosecution. In order that the Court's basis of decision be properly identified, I shall enlarge upon that point.

Silence does not always constitute assent. As the authorities relied upon by defendants stress, there is a duty to speak only "under circumstances which reasonably called for a reply", *Hellenic Lines Ltd.* v. *Gulf Oil Corp.,* 340 F.2d 398, 401 (2d Cir. 1965); and the offeror, seeking to enforce an unspoken bargain, may do so only in circumstances where he "reasonably and in good faith" places such a construction upon the silence of the offeree. 1 Williston, *Contracts,* ¶¶ 90, 91A (3d Ed. 1957). It is necessary, therefore, to consider the context of these negotiations with the SEC; and to determine whether defense counsel's professed reliance upon the SEC's silence, on the point of criminal reference, may be regarded as reasonable.

The question is not free from difficulty; and the difficulty is inherent in the relationship of the parties, where both civil and criminal inquiries may arise from the same transactions. This is the sort of situation which has led to prior expressions of judicial concern. In *United States* v. *Parrott,* 248 F.Supp. 196, 201 (D.D.C. 1965), the court expressed the general view "that parallel civil and criminal inquiries should not be commingled." In *United States* v. *Parrott,* 425 F.2d 972 (2d Cir.), *cert. den.,* 400 U.S. 824 (1970), relied

upon by the Government in the case at bar, the Second Circuit, although upholding a conviction for securities violations following an SEC inquiry, noted that "the claim that pressing the civil proceedings while allegedly concealing the intent to prosecute criminally was unfair has considerable appeal." 425 F.2d at 976. However, on the question of silence, pure and simple, uncomplicated by any element of concealment, I conclude that defendants' reliance must be characterized as unreasonable.

Experienced defense counsel are, perforce, aware that in cases of this nature, "more than civil proceedings might be contemplated", *United States* v. *Parrott, supra,* at 425 F.2d at 976. In these circumstances, if they wish to condition their clients' participation or cooperation in a civil proceeding, conducted by the SEC, upon an agreement by the SEC not to make a criminal reference, it is the obligation of counsel to make that specific request, and then be guided by the SEC's response to it. That is precisely the procedure followed by counsel for Messrs. Kreisler and Weston in this very case. In the Court's opinion, the burden of requesting and obtaining an express agreement from the SEC, in cases of this nature, falls reasonably upon the shoulders of defense counsel; and it follows that defense counsel cannot reasonably equate silence on the part of the SEC with assent.

I am mindful of Mr. Gould's testimony that, on the basis of this formidable experience in dealings with the SEC, he was entitled to construe silence as assent in the case at bar. But the specific cases to which he referred in his testimony did not withstand the analysis furnished by the Government's further explication of those cases. Furthermore, a holding that SEC staff attorneys, by silence alone, may place the Government in a position where no subse-

quent criminal charge can be made, has enormous potential for mischief. Courts would be called upon to decide just what it was that defendants or their counsel said during the course of a civil inquiry; if the SEC attorneys had actually heard or appreciated what was being said or intimated; and what, if anything, the SEC representatives said in response. SEC staff members should not bear the responsibility of constantly proclaiming that no agreement on a criminal reference is to be implied, at the risk of foreclosing subsequent criminal charges. A holding imposing such a duty would open a Pandora's box of potential litigation.

In the case at bar, however, more is presented than SEC silence in the face of defendants' expressed desire to avoid a criminal reference. I have found that on two separate occasions, the SEC representatives maintained that silence when individuals clearly indicated their understanding that an agreement not to make a criminal reference had actually been achieved. Those incidents involve Streit's discussion with Tucker and Perlmutter on September 30, 1975 (see Finding of Fact 27 *supra*), and Ostrow's discussion with Tucker and Perlmutter on October 20 (see Finding of Fact 31 *supra*). Furthermore, in October of 1975 Perlmutter had assured attorney Gordon, in response to the latter's request for information on behalf of a prospective new director, that there would be no criminal reference (see Finding of Fact 29 *supra*). Finally, the SEC actually made a criminal reference, during the course of the civil settlement negotiations, and prior to consummation of that settlement, and did not disclose the fact of the criminal reference to defendants or their counsel, although the SEC representatives knew that a primary objective of the defendants in the negotiations was the avoidance of a criminal

reference, and that knowledge that a criminal reference had been made would be of material significance to the defendants (see Findings of Fact 16, 35).

Quite obviously, these facts give an additional dimension to the case. We are no longer concerned with defense counsel expressing a desire to avoid a criminal reference, and the SEC representatives failing to respond specifically to that expressed desire. The two incidents of silence just referred to (Streit conversation and Ostrow conversation) are of a different kind, for the SEC representatives were on notice, from what was being said to them, that the speakers were under the impression (reasonable or not, justified or not), that an agreement not to make a criminal reference had been achieved. As for Perlmutter's assurance to attorney Gordon (who was not directly involved in the case, and whose evidence I have no hesitation in accepting), an additional element appears: here, the SEC representative affirmatively indicated that there would be no criminal reference. And the final element presents the question of whether the SEC, in the circumstances of this case, was under a duty to disclose the fact that a criminal reference had in fact been made.

Before turning to these additional elements, I consider the defendants' threshold argument on the making of the criminal reference, namely, that the manner in which the case was referred to the United States Attorney contravened the pertinent statute, regulations, and SEC procedures. In essence, defendants argue that since the statute, 15 U.S.C. §§ 77t(b), 78(u)(b) and the regulations, 17 C.F.R. § 202.5(b), provide that "the Commission" may refer matters to the Department of Justice for possible prosecution, it is only the Commissioners themselves who have such authority.

In the case at bar, it is undisputed that the criminal reference took the form of an informal advice from Tucker of the SEC to Wing of the United States Attorney's office. This informal procedure has grown up over the past several years, so that it now represents the manner in which most criminal references are made, at least in this district. I am asked to declare this informal procedure illegal, and dismiss the indictment on that ground alone.

I decline to invalidate the working relationship which has grown up between the SEC regional offices and the offices of United States Attorneys in recent years. As explained in the evidence of Mr. Sporkin, the Chief of the SEC Division of Enforcement, the informal procedure is time-saving and the result of various practical considerations. Nothing in the statute or regulations expressly prohibits any method of criminal reference other than a reference by the Commissioners themselves; accordingly prohibition must be found, if at all, by necessary implication. But I conclude that the SEC may, without violating its governing statutes or its own regulations and procedures, sanction this method of informal criminal references. There are sufficient due process safeguards in the grand jury machinery itself, and defendants such as those involved in the present case are not legally entitled to insist that the SEC restrict itself to one particular procedure, even though that procedure, if followed, might have given defendants opportunities to urge, at an administrative level, that no criminal reference be made. Compare *SEC* v. *National Student Marketing Corp.,* 538 F.2d 404, 407 (D.C.Cir. 1976), *cert. den.,* U.S. (1977).

We come, then, to the question of the propriety of the SEC's actions in this case, and the consequence of any impropriety. The Court's holding is limited to the par-

ticular circumstances of the case, as revealed by the evidence.

I am constrained to hold that Messrs. Tucker and Perlmutter of the SEC New York regional office behaved improperly in this case. Silence in the face of Streit's and Ostrow's expressed belief that an agreement in respect of a criminal reference had been reached was misleading, and in the circumstances wrongful. *A fortiori,* Perlmutter's assurance to Gordon, that no criminal reference would be made, was misleading and wrongful. This pattern of behavior is particularly deplorable in view of the fact that the SEC representatives had quite clearly determined to make a criminal reference as soon as the civil settlement was "wrapped up"; that concealed purpose furnishes the motive for misleading counsel, but hardly serves to excuse the behavior.

The SEC's strategy of concealment led logically to nondisclosure of the fact that, on December 1, a criminal reference had actually been made. In the circumstances of the case, I conclude that principles of equity and fairness required the SEC representatives to advise defense counsel immediately that a criminal reference had been made. In reaching that conclusion, I am assisted by the testimony of Mr. Sporkin, who responded to a hypothetical question put by the Court which recreated the state of facts as of December 1 in the case at bar, and inquired as to whether the SEC staff members were obligated to disclose the fact of the criminal reference to defense counsel. Mr. Sporkin testified:

> "On my own personal view, knowing all the facts you were saying, and this is the way I live my life and as a fairness matter, strictly in terms of fairness, I certainly would have—I don't know whether I would have told them that the matter is over in the courthouse now, but I certainly would have said to him—because I might not be permitted to tell him —but I certainly would have said to him discount 100 per cent any thought in your mind that this will settle a possible criminal action. Take that as zero in your determination. If you still then want to go through with the settlement, that is up to you, but it clearly goes only to the question of the negotiation of the civil aspects of the case." Tr. 768-769.

In his following testimony, Mr. Sporkin made it clear that he would, in such circumstances, tell defense counsel specifically "that the matter is over in the courthouse now", unless there were particular circumstances militating against such specific advice. I perceive no such circumstances in the case at bar; but even if they existed, Mr. Sporkin's testimony makes it clear that, "in terms of fairness", a very strong signal should have been sent to defense counsel as soon as the criminal reference had been made.

I am grateful to Mr. Sporkin for the candor with which he responded to that question; and I share his view of what constitutes fair dealing in such circumstances. I fully recognize that, in Mr. Sporkin's further view, the appropriate remedy for defendants in such a position is to reopen the civil consent judgments, and that the criminal indictment should not be adversely affected. On that question of appropriate remedy, I cannot agree with Mr. Sporkin, for reasons set forth *infra.*

I conclude, in sum, that the SEC representatives in question engaged upon a deliberate course of concealment, first of their intention to make a criminal reference, and then of the fact that the reference had been made, in order to obtain civil consent judgments imposing substantial

sanctions upon the defendants.[9] A primary objective of Fields and Friedman, and the sole objective of the other defendants, in agreeing to such sanctions was the avoidance of a criminal reference, as the SEC representatives well knew. In these circumstances, the conduct of the SEC representatives cannot be condoned. It is a sad irony that representatives of a governmental agency dedicated to the prevention of fraudulent and misleading statements fell into this particular pattern of behavior.

I do not hold that SEC negotiators are obligated, in all circumstances, to keep defense counsel *au courant* as to their tentative or preliminary thoughts on a *future* criminal reference; or that equally preliminary conversations between the SEC and a United States Attorney must be promptly revealed. What I do hold is that, in the circumstances of this case, the SEC's nondisclosure of the *present fact* of a criminal reference, viewed in the context of all that had gone before, was inequitable and wrong.[10]

The wrongfulness of the SEC's behavior having been demonstrated, the question of appropriate remedy, if any, arises. There are three initial alternatives:

[9] The sanctions are set forth in detail in footnote 2.

[10] I do not overlook the fact, stressed by the Government, that each consent to judgment in the civil litigation contained a clause which read:

> "This consent is given by defendants Fields, Friedman and Davis voluntarily and no promise or threat of any kind whatsoever has been made by plaintiff Commission or any member, officer, agent, or representative thereof to induce Fields, Friedman, and Davis to enter into this consent."

Counsel for defendants, in the course of pressing their "silence is assent" argument, denigrated this paragraph as "boilerplate". Whatever effect such standard disclaimers may have in other circumstances, cf. *Blackledge* v. *Allison*, —— U.S. —— (May 2, 1977), 45 U.S. L.W. 4435, it cannot serve to excuse the SEC's wrongful concealment in the case at bar.

(1) An admonishment to the SEC, intended to prevent future occurrences, but unaccompanied by any sanction.

(2) Permitting the defendants to reopen the consent judgments entered in the civil suit, but taking no action with respect to the indictment. That is the course urged upon the Court by the Government, in the event that impropriety is found.

(3) Dismissing the indictment in its entirety. That is the course urged upon the Court by the defendants, who seek to embrace the confines of the remedy to include transactions not referred to in the civil complaint or settlement.

A perception of governmental impropriety vests the courts with discretion in prescribing the appropriate remedy. *Santobello* v. *New York*, 404 U.S. 257, 262-263 (1971). The source of that discretion is the supervisory power in criminal cases which may be exercised by the Supreme Court, *McNabb* v. *United States*, 318 U.S. 332, 340 (1943); or in appropriate cases by the Courts of Appeals, *United States* v. *Jacobs*, 547 F.2d 772, 776 (2d Cir. 1976), or, where necessary and appropriate, by the district courts, *United States* v. *Paiva*, 294 F.Supp. 742, 746 (D.D.C. 1969). Mr. Justice Frankfurter, concurring in *Sherman* v. *United States*, 356 U.S. 369, 380 (1958) stated the general principle:

> "Insofar as they are used as instrumentalities in the administration of criminal justice, the federal courts have an obligation to set their face against enforcement of the law by lawless means or means that violate rationally vindicated standards of justice, and to refuse to sustain such methods by effectuating them. They do this in the exercise of a recognized jurisdiction to formulate and apply 'proper standards for the enforcement of the federal criminal

> law in the federal courts,' *McNabb* v. *United States,* 318 U.S. 332, 341, an obligation that goes beyond the conviction of the particular defendant before the court. Public confidence in the fair and honorable administration of justice, upon which ultimately depends the rule of law, is the transcending value at stake."

I conclude without difficulty that a simple admonishment, unaccompanied by any sanction, is inappropriate. One purpose of a sanction in such circumstances is to discourage comparable governmental activity in the future; the Second Circuit in *United States* v. *Jacobs, supra,* characterized this as a "didactic purpose", 547 F.2d at 778; compare *United States* v. *Estepa,* 471 F.2d 1132, 1137 (2d Cir. 1972).

Nor can I agree with the Government that a reopening of the civil consent judgments constitutes a sufficient remedy. The guiding principles are those of equity. If the consent judgments are vacated, and all civil sanctions removed, TDA shareholders will be required to restore to these particular defendants monies which the defendants were obliged, by the civil settlement, to disgorge. That is not, in the circumstances of the case, an appealing resolution. Furthermore, it is impossible, by reopening the civil consent judgments, to restore the individuals concerned to the positions in which they found themselves at the time of the nondisclosure of the criminal reference, in December of 1975, and the subsequent execution of the consent judgments. That is particularly true in the case of defendant Davis, who as noted resigned from his law partnership and saw his practice come to a virtual end, as the direct consequence of the SEC's bargained-for withdrawal of Davis from practice before the Commission. The same situation arises, albeit with lesser dramatic force, in respect of the activities

which the other defendants were obliged to give up as a result of the consent judgments. I conclude that reopening of the civil suit is not a sufficient remedy.

I also reject the remedy put forward by the defendants, namely, dismissal of all charges and counts of the indictment. Again, returning to the touchstone of equity, I perceive no basis upon which transactions not revealed by the defendants to the SEC, and consequently not referred to in the civil litigation or its subsequent settlement, are foreclosed from criminal prosecution in the circumstances of this case. It is true, as defendant Fields points out, that in the course of its own inquiry the SEC developed some information about the November, 1971 stock manipulations of which Fields stands accused by the indictment. The SEC apparently did not develop sufficient information concerning those transactions to include them in its civil complaint; but the grand jury developed sufficient information during its own inquiry to vote an indictment. Fields, who appeals in large part to the doctrine of equitable estoppel is in no position to make such an argument with respect to transactions which he did not reveal to the SEC.

Similarly, there is no basis upon which defendant Berge can appeal to equity, in order to bar prosecution of count twelve of the indictment, which charges him with making false statements to the SEC during its inquiry. It is true, as Berge points out, that the SEC, in evaluating that aspect of the case concerning which Berge testified, apparently did not accept Berge's testimony as accurate. But it hardly follows that the Government is barred, by its settlement of a civil action dealing with entirely separate issues, from prosecuting a charge of false statements during the course of its inquiry. Berge contends that his statements were not in fact false. That is an issue for the trial jury to determine.

The Court concludes that, in the circumstances of the case, the proper remedy is to strike from the indictment all reference to transactions which were disclosed to the SEC, and were referred to in the civil suit and its subsequent settlement. I fully recognize that any court "finds itself in a veritable dilemma when its choice is between vindicating a rule by sanction and allowing a possibly guilty person to escape." *United States* v. *Jacobs, supra,* at 775. However, I am in accord with the observation of Mr. Justice Holmes, dissenting in *Olmstead* v. *United States,* 277 U.S. 438, 470 (1928):

> "For my part I think it a less evil that some criminals should escape than that the Government should play an ignoble part."

In the case at bar, the regrettable fact is that the Government, acting through representatives of the SEC, played "an ignoble part"; and I have concluded, not without reluctance, that indicated charges of the indictment must be dismissed in consequence.

The Government argues that a showing of prejudice in the criminal proceeding is a condition precedent to the contemplated remedy. But the supervisory powers of the courts do not require, as a condition to their exercise, that the defendant have suffered some specific damage in the preparation of his defense. A showing that the administration of justice itself has been prejudiced, by inequitable behavior, is sufficient to invoke those supervisory powers.

Illustrative of the point is *In the Matter of Doe,* 410 F.Supp. 1163 (E.D.Mich. 1976), wherein defendant offered to surrender a quantity of cocaine to federal authorities in return for a guarantee that he would not be interrogated concerning its source or the circumstances under which he

procured it. After having acceded to the defendant's terms, the Government called him as a grand jury witness, and caused an order of immunity to be conferred upon him. Defendant's motion to vacate that order was granted:

> ". . . [J]udicial integrity and the 'interests of justice' . . . would be offended if the court ratified the government's broken promise to Doe by reaffirming the immunity order . . .
>
> "Neither may the government insist that Doe demonstrate some prejudice before claiming a violation of his rights in the government's broken promise. No prejudice, apart from that suffered by the administration of justice was apparent in *Santobello.*" 410 F.Supp. at 1166.

In *United States* v. *Rodman, supra,* it is apparent from analysis of the proceedings before the district court that the Government consented to the suppression of any evidence obtained by the prosecutor from Rodman as the result of his agreement with the SEC, thereby eliminating any element of prejudice in defense of the criminal charge. However, the district court concluded that, in the circumstances of the case, the indictment must nonetheless be dismisssed.

I recognize that, in *Doe* and *Rodman,* specific agreements on the part of government agents were found. Although no such finding is made in the case at bar, *Doe* and *Rodman* nevertheless illustrate the proposition that indictments are subject to dismissal, in an appropriate case, even in the absence of specific prejudice to the criminal accused.

In defending the actions of the SEC, and arguing that they should have no effect upon the indictment, the Government relies primarily upon three decisions of the Second Circuit: *United States* v. *Parrott,* 425 F.2d 972 (2d Cir.

1970); *United States* v. *Light,* 394 F.2d 908 (2d Cir. 1968); and *United States* v. *Rubinson,* 543 F.2d 951 (2d Cir. 1976). These cases are of no particular assistance in the resolution of the case at bar, primarily because the governmental acts reflected by those cases bear no meaningful resemblance to the pattern of behavior which emerges from the present record.

Thus in *Parrott,* a prosecution for violation of securities laws, the SEC had conducted a prior civil proceeding in which the defendants had testified. The defendants then contended that "pressing the civil proceedings while allegedly concealing the intent to prosecute criminally was unfair", 425 F.2d at 976. As noted *supra,* the Second Circuit viewed this argument as one having "considerable appeal". However, the argument was rejected on the facts of the case, since the only unfair consequence of which defendants complained was the development of information during the civil proceeding. The Second Circuit pointed out that, in respect of such information, "the Parrotts could have exercised their privilege against self-incrimination in the civil proceedings"; furthermore, as the Court pointed out, that prior testimony in the civil proceedings "was not used by the government in its case in chief or in cross-examination of Forrest Parrott, the sole defense witness." 425 F.2d at 976. Unlike the case at bar, there was no evidence in *Parrott* of a negotiated civil settlement, or circumstances which rendered nondisclosure of the making of a criminal reference unfair. There is, in short, considerably more appeal to the argument of unfairness in the case at bar than could be suggested in *Parrott.*

Light also involved a prosecution for violation of the securities laws. Defendants, having been convicted, con-

tended on appeal that the trial court should have suppressed certain books and records obtained by the SEC during a civil injunction proceeding, and later turned over to the United States Attorney's office. The defendants had consented to the removal and examination of the books; they argued that by turning the records over to the United States Attorney, the SEC exceeded the consent given. Rejecting the contention, the Second Circuit stated:

> ". . . Once records have been voluntarily turned over to a government agent, the government is not guilty of fraud or deceit in failing to apprise the subject of a change in the character of the investigation, for he is made aware of the risks attendant upon a voluntary disclosure by the warning inherent in the request." 394 F.2d at 914.

Again, the negotiation of a civil settlement, and the attendant circumstances which required disclosure of the making of a criminal reference, are not present in *Light.* The Second Circuit in *Light,* observing that the defendants in that case were fully aware of risks inherent in a voluntary disclosure of documents, found that the Government was "not guilty of fraud or deceit in failing to apprise the subject of a change in the character of the investigation . . ." The Government, in its brief (p. 37), seeks to expand that holding into a ruling "that the SEC is not obligated to apprise defendants of a criminal reference" in any circumstances. I do not give so broad a reading to *Light.* Each case turns on its own circumstances; indeed, the Court in *Light* was careful to condition its holding upon "the absence of a showing that [the documents] were obtained through fraud and deceit in the first instance", 394 F.2d at 914, a statement which recognizes by

implication that fraud and deceit may be shown in other circumstances, with possibly different consequences.

Rubinson follows *Parrott* in holding that a contention based upon unfairness, but limited to a claim that information was developed during the course of a prior civil proceeding, is legally insufficient, in view of the availability of the Fifth Amendment privilege in the civil proceeding. In *Rubinson,* the Second Circuit quoted the observation in *United States* v. *Kordel,* 397 U.S. 1, 11 (1970), that a governmental agency need not invariably "choose either to forego recommendation of a criminal prosecution once it seeks civil relief, or defer civil proceedings pending the ultimate outcome of the criminal trial." In the case at bar, the Court imposes no such choice. All that is required by the Court's holding is that a governmental agency refrain from concealing its recommendation of criminal prosecution, when within the context of its effort to obtain civil relief such concealment is unfair.

In surveying the recent decisions of the Second Circuit, I find more guidance in *United States* v. *Jacobs, supra.* In *Jacobs,* a special government attorney who was a member of the Strike Force, 28 U.S.C. § 543, presented a case to a grand jury. The attorney departed from the well-recognized practice of United States Attorneys in the Circuit by failing to warn the defendant that he was a target of the investigation. Because of that failure, the Second Circuit, in the exercise of its supervisory powers, dismissed count two of the indictment, which charged the commission of perjury before the grand jury. The Court of Appeals took comfort, in *Jacobs,* from the fact that the substantive crime charged in the indictment was not subject to dismissal. In the case at bar, the dismissals which I am ordering work a more drastic effect upon the indictment,

and so that particular sense of comfort is diminished; however, the impropriety of the SEC representatives in the case at bar clearly rises to a higher level than that demonstrated by the inadvertent omission of the Strike Force prosecutor in *Jacobs.*

The Government also points out that many cases dismissing indictments on the basis of governmental misbehavior arise out of misconduct of prosecutors. In the case at bar, I find no fault with the actions of any member of the office of the United States Attorney for this district. The impropriety that I have found is confined to representatives of the SEC. But consideration of improper and inequitable behavior is not limited to the confines of the prosecutor's office. It is Government, in all its offices and functions, which must be held to standards of fair and honest dealing with the citizens of the Republic. It is well settled that conduct of members of Government agencies other than the Department of Justice, or a United States Attorney's office may operate to bar subsequent criminal prosecution. *United States* v. *Rodman, supra* (SEC representatives); *United States* v. *Orman,* 417 F.Supp. 1126 (D.Col. 1976) (misconduct of federal drug enforcement agents); compare *United States* v. *Tweel,* reported in P-H Fed. Inc. Taxes, 39 AFTR2d 77-1223, decided April 8, 1977 (5th Cir.), and *United States* v. *Payner,* case No. CR76-305 (N.D.Ohio, E.D.), opinion filed April 28, 1977, in which the courts suppressed evidence obtained as the result of misconduct of IRS agents.

In the light of the facts as found, and in the exercise of the Court's supervisory powers, I exercise my discretion and strike from the indictment those charges and allegations referred to in the civil litigation.

II.

ALTERNATIVE GROUNDS FOR DISMISSAL

The foregoing discussion is sufficient to dispose of all allegations in the indictment which mirror disclosures made by the defendants to the SEC, and are consequently reflected in the civil suit and settlement.

Quite apart from this basis for decision, there are alternative and compelling legal reasons why certain aspects of the indictment must be dismissed. These aspects relate to the ERD transactions, as to which the indictment states no offense under pertinent authority. These contentions were also raised in the defendants' motion papers. In order that the case be fully stated for the possible consideration of higher authority, I shall state the reasoning which underlies these alternative conclusions.

A. The Materiality of the ERD Transactions to the Public Offering

Defendants' counsel move to dismiss the portions of the indictment relating to the public offering (i.e., counts one, two and three) for failure to state an offense in that the means allegedly employed to implement this fraudulent scheme were, in their view, unrelated to the "offer or sale" of the securities at the November 10, 1971 public offering, as required by Section 17. Basically, it is contended that neither Zammas' activities nor the deficient prospectus caused any investor to be defrauded in the purchase of TDA stock. As Fields' and Friedman's counsel succinctly state, the public offering counts lack ". . . a causal connection between the fraud charged and the actual sale of the security . . ." In essence, defendants urge that these devices

were simply not material to the public offering because they did not bear on the actual financial health of TDA, and consequently their commission (in the case of the Zammas manipulation) or omission from the prospectus (in the case of the Westcalind and ERD kickbacks) could not have caused the damage suffered by individuals investing in TDA through the public offering.

As noted *infra* at p. 56, notions of materiality and causation developed in the civil context are fully applicable to criminal prosecution of securities act violations. What is lacking in the public offering counts, defendants argue, is "transaction causation", see *Schlick* v. *Penn Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. den.*, 421 U.S. 976 (1975), since the averred omissions, being immaterial to the true status of TDA, could not have induced the purchase of its stock.

With respect to the maneuverings of Zammas, this claim is plainly without merit. Both his reciprocal purchases and spot acquisitions of TDA are "classical" methods of artificially stimulating the demand for a given stock and thereby bolstering its market price, *United States* v. *Corr*, 543 F.2d 1042, 1045-47 (2d Cir. 1976); *United States* v. *Koss*, 506 F.2d 1103, 1108 (2d Cir. 1974), *cert. den.*, 421 U.S. 911 (1975). As such, these manipulations would clearly operate as a fraud upon investors and consequently, the motion in this regard is denied.

A finer analysis is needed with respect to the role the deficient prospectus is averred to have played in the TDA public offering. Defendants argue, somewhat opaquely, that the activities deliberately omitted from the prospectus—namely the illicit Westcalind commission and the April and May, 1971 ERD kickbacks—could not have had, and did not in actuality have, any effect upon the fairness or

legitimacy of the TDA stock purchases. This apparently follows from the fact that those transactions, reprehensible though they may be, did not impact on the issuing company's financial condition such that innocent purchasers were lured into investing in a corporation whose true condition had been materially misrepresented to them. Since the effect of those manipulations was not to waste corporate assets or deplete its treasury, the purity of the actual market transactions in TDA were not sullied. In short, defendants' averred omissions did not bear on the economic well being of the company such that their nondisclosure led unwary purchasers to buy into a company which had in reality been damaged by those peculations.

In theory, this point is well taken. It is inapplicable, however, to the Westcalind "finder's fee" since the $50,000 commission involved there was paid by the corporation, and represents precisely the kind of self-dealing which debilitates the corporation and thereby misleads purchasers of that company's stock who were unaware of it, *e.g., United States* v. *Aloi,* 511 F.2d 585 (2d Cir. 1975). Consequently, the motion in this respect must be denied.

The converse situation is presented by the ERD transactions, and a likewise opposite conclusion is reached. It is true that these schemes, if proven, would constitute blatant instances of the kind of over-reaching condemned by our securities laws. As pleaded, however, these transactions did not in any discernible way bear upon the financial condition of the company whose shares were being publicly marketed. That is, defendants' ill-gotten gains had not been at the expense of TDA, and consequently the failure to disclose such manipulations was not relevant to a purchaser's informed decision on the merits of investing in the company. Neither the indictment nor the Government's

memorandum of law contain any indication of how the ERD transactions could have reflected upon the *company's* true financial status, nor is any effect implicit from the nature of those dealings. The indictment does state in paragraph 10(f)(iv) that the money used by Bernardi as a down payment on the TDA stock purchased from ERD in April, 1971 was obtained as a loan from White Lamps, Inc., a TDA subsidiary. However, there is no indication that this obligation was not repaid, and consequently, there appears to have been no raiding of TDA's treasury in order to facilitate the ERD transactions.

At most, the nondisclosures of the ERD scheme deprived investors of the knowledge that certain TDA directors and officers had larceny in their hearts. However, Section 17 cannot be read so broadly as to require the inclusion of character profiles of key personnel in each prospectus. Defendants' counsel adduce many learned cases indicating that such revelation is beyond the limited scope, purpose and mission of Section 17; no discussion of such authority is necessary here since to state the proposition is to recognize its invalidity.

To be sure, the ERD schemes had their victims, to wit, ERD itself and the unidentified group of seed shareholders who were induced to sell their unregistered TDA shares without the knowledge that its restrictions would be lifted immediately thereafter. As defrauded *sellers* of securities, those shareholders are unfortunately not within the purview of Section 17. This is the dilemma which pervades the public offering counts of the indictment; the illegality charged is basically a Section 10(b) violation in that the injured parties were the deceived sellers of TDA stock. A prosecution for violation of that provision would appear to be barred by the statute of limitations, and consequently, the

Government has attempted to resuscitate the ERD schemes by portraying them as acts in furtherance of a conspiracy. For the reasons just stated that approach is inappropriate, and the motion to dismiss the public offering counts for failure to state an offense is granted to the extent that the ERD transactions, portrayed in paragraphs 10(f) and 10 (g), are stricken. Accordingly, no evidence concerning those activities will be admitted into evidence in support of the charge that the prospectus was materially deficient. See *United States* v. *Wolfson,* 437 F.2d 862 (2d Cir. 1970).

B. The Materiality of the ERD Transactions to the Proxy Solicitations

Defendants named in counts 4 and 5 of the indictment, charging violations of the proxy section of the Exchange Act, 15 U.S.C. § 78(n), and a rule promulgated thereunder, 17 C.F.R. 240.14a-9, move for dismissal of those charges on a theory similar to that with which they attacked the legal sufficiency of the public offering counts.

Count 4, which names Fields, Friedman and Davis as defendants, relates to a solicitation of proxies from TDA shareholders. Count 5, which names Fields, Friedman, Davis and Berge as defendants, relates to a solicitation from Westcalind shareholders. Both solicitations took place in December of 1971. Violation is said to lie in omission from the proxy statements of the several matters alleged in count 1 of the indictment.

The TDA solicitation of proxies related to the annual meeting of shareholders of that company, to be held on January 25, 1972. Two specific items of business were referred to: a proposal to amend the company's stock option plan, and the election of three directors.

The Westcalind proxy solicitation referred to the annual meeting of January 31, 1972. The only specific order of business covered by the solicitation was the election of six directors.

The defendants concerned first attack these counts on the ground that Section 14(a) applies only to proxy solicitations in respect of "registered" securities, and there is no allegation in either count that TDA's common stock was registered. It is correct that this element is not alleged with specificity in the counts under consideration; but I agree with the Government that the reference to the TDA common stock, alleged in other counts of the indictment to have been offered to the public for sale, supplies the element of registration to the counts in question by necessary implication. 15 U.S.C. § 781(g); cf. *United States* v. *Silverman,* 430 F.2d 106, 109-12 (2d Cir. 1970).

As a second line of attack, the defendants contend that the alleged omissions were not alleged to be material to the proxy statements, and that the omissions are, in fact, immaterial.

I am not prepared to dismiss these counts of the indictment on the ground of a failure to set forth the proxy statements in detail, or to allege with specificity the manner in which the omitted statements may have been material to shareholders. But the defendants' contention of non-materiality may appropriately be considered, prior to trial, within the context of a motion to dismiss. That is to say, if it is apparent that at the conclusion of the Government's case the defendants would be entitled to dismissal of these counts as a matter of law, the nettle might as well be grasped at this time.

For this reason, the Court has familiarized itself with the contents of the proxy statements, as summarized above.

I conclude that count 4, relating to the TDA proxy solicitation, is subject to dismissal on this alternative ground, but that count 5, relating to the Westcalind proxy solicitation, is not.

Count 4 must be dismissed because there is no causal connection between either of the acts scheduled for the TDA stockholders' meeting (amendment of the stock option plan and election of directors) and the various acts and transactions alleged in count 1 of the indictment.

In considering the necessary elements of a Section 14(a) violation, we may look for instruction to civil cases invoking the statute. The elements of the violation are the same; the only practical difference is that in a civil case the violation must be established by a preponderance of the evidence, whereas in a criminal case the Government must "meet the stricter requirement of satisfying the jury beyond reasonable doubt." *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.,* 320 U.S. 344, 355 (1943); and see *United States* v. *Charnay,* 537 F.2d 341, 348 (9th Cir. 1976), *cert. den.,* —— U.S. —— (1977) (45 U.S.L.W. 3416), and *United States* v. *Clark,* 359 F.Supp. 128, 130 (S.D.N.Y. 1973).

It is well settled, by the civil cases, that there must be a causal connection between the non-disclosures in the proxy solicitation and the transaction accomplished or implemented by means of the proxy solicitation. Again, *Schlick* v. *Penn-Dixie Cement Corp., supra,* characterizes this element as one of "transaction causation"; Judge Oakes's opinion quotes with approval this statement from *Weiss* v. *Sunasco, Inc.,* 316 F.Supp. 1197, 1205 (E.D.Pa. 1970):

> ". . . The proper test is whether the proxy solicitation is 'an essential link in the accomplishment of the transaction' giving rise to the litigation, irrespective of the fact that other possibilities were available to management." 507 F.2d at 383.

See also *Robbins* v. *Banner Industries, Inc.,* 285 F.Supp. 758 (S.D.N.Y. 1966); *Barnett* v. *Anaconda Co.,* 238 F.Supp. 766 (S.D.N.Y. 1965); *Epic Enterprises, Inc.* v. *Brothers,* 395 F. Supp. 773 (N.D.Okla. 1975); *Walner* v. *Friedman,* 410 F. Supp. 29 (S.D.N.Y. 1975). This requirement of causal connection reflects the purpose of Section 14(a), as described by the Supreme Court in *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 431 (1964):

> "The purpose of § 14(a) is to prevent management or others from *obtaining authorization for corporate action* by means of deceptive or inadequate disclosure in proxy solicitation." (emphasis added)

In *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375, 381 (1970), the Court observed that the proxy statute:

> "[W]as intended to promote 'the free exercise of the voting rights of stockholders' by insuring that proxies would be solicited with 'explanation to the stockholder *of the real nature of the question for which authority to cast his vote is sought.*'" (emphasis added)

In the case at bar, count 1 of the indictment alleges a number of illegal acts on the part of defendants Fields, Friedman and Davis. However, none of these acts, all of which had been accomplished prior to the stockholders' meeting referred to in the TDA proxy solicitation, bore any direct relationship to the business sought to be accomplished at the meeting, and referred to in the proxy statement. Accordingly, direct "transactional causation", resulting from the non-disclosure of those prior acts, cannot be demonstrated.

The remaining argument left to the Government is that those prior acts so reflect upon the character of Mr. Friedman, one of the three nominees for election as director, that they should have been disclosed in the proxy solicitation. But I reject that argument, on the authority of Judge Owen's decision in *Levy* v. *Johnson, et al.*, — F.Supp. — (S.D.N.Y. Feb. 16, 1977) (Dkt.No. 76 Civ. 1187). In *Levy,* plaintiff claimed a Section 14(a) violation in that the defendants failed to include in proxy material the fact of previous improper payments to foreign governments; plaintiff alleged that this non-disclosure resulted in the re-election of the defendant directors, who then made further improper payments abroad. Judge Owen, dismissing the complaint, held that the necessary element of "transaction causation" was missing. His opinion reads in pertinent part:

> "Section 14(a) was designed 'to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation.' *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 431 (1964). In the instant case, the only corporate action sought to be authorized by the proxy solicitation in question was the directorial elections of 1970 through 1975. The alleged improper payments were not the subject of the proxy solicitation. If at all, they represent a breach of defendant directors fiduciary duty to their corporation. Lacking, therefore, is the 'transaction causation' component of a section 14(a) claim that is required by the Second Circuit. *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F.2d 374, 381-83 (2d Cir. 1974); *Walner* v. *Friedman,* 410 F.Supp. 29, 32 (S.D.N.Y. 1975)
>
> "Plaintiff's argument, that 'but for' the proxy violations the defendant directors would not have been re-elected and could not have subsequently authorized the alleged improper payments, does not meet the transaction causation standard. If the court were to adopt the plaintiff's standard, any suppression of a director's impropriety in proxy materials for re-election, followed by a further impropriety after re-election, would state a claim under federal law. It was not intended that, by reason of a proxy violation, a purely state claim might be so transformed into a federal cause of action. Count II of plaintiff's complaint must be dismissed for failure to state a claim upon which relief can be granted." Slip opinion, at 4-5.

In the light of these authorities, count 4 of the present indictment must be dismissed as to all defendants named in that count.

I reach a different conclusion in respect of count 5; and, in so doing, again rely upon a case decided by Judge Owen, *Securities and Exchange Commission* v. *Kalvex, Inc.,* 425 F.Supp. 310 (S.D.N.Y. 1975). In that case, proxies were solicited for the election of one Ingis as a director. In its civil complaint, the S.E.C. charged Ingis, among others, with participating in "a scheme to funnel money through a dummy corporation for the purpose of secretly receiving kickback payments from a Kalvex supplier"; it was also charged "that Ingis siphoned off corporate funds from Kalvex for personal use by submitting expense vouchers and obtaining reimbursements therefor from Kalvex for expenses unrelated to any corporate purpose." 425 F.Supp. at 312. Judge Owens held that such activities were material in respect of the stockholders' decision whether or not to re-elect Ingis as a director:

> "I find that these facts were material and therefore were required to be disclosed in the proxy statements

> in accordance with Item 7 of Schedule 14A. I further find that these facts were concealed, in violation of Rule 14a-3. Ingis knew he was standing for election as a director; he knew that the proxy statements which had been filed and distributed were false and misleading. I believe that a stockholder would have carefully weighed his vote had these facts concerning Ingis been revealed. *One does not elect as a director an individual who is using the corporation he represents for personal gain.*" 425 F.Supp. at 315. (emphasis added)

In the case at bar, count 5 of the indictment relates to a solicitation of proxies from Westcalind stockholders, for the purpose of electing Messrs. Fields, Berge, Davis and Friedman, as directors of that corporation. Count 1 of the indictment, at ¶10(e), alleges that in March of 1971 Fields and Friedman:

> ". . . caused Westcalind to pay a 'finder's fee' of $50,000 to Bernardi Resources Corp. ('Bernardi'), a private investment company, which had not and did not perform any service of any kind to Westcalind or anyone else in connection with said acquisition, and arranged for Bernardi to kick back $35,000 in cash to said defendants; . . ."

This is precisely the sort of direct depradation of corporate assets by a director that was presented in *Kalvex.*

I perceive no difficulty in reconciling the decisions in *Levy* and *Kalvex.* Where individuals present themselves for election as directors of a corporation, and fail to disclose in proxy solicitations that they have, in effect, been stealing from the very corporation which they desire to continue to "serve", the necessary element of "transaction causation" is present, and a violation of Section 14(a)

arises. To hold otherwise would make a mockery of the proxy statute and regulations. That is the situation presented by *Kalvex;* that is the situation alleged in the present indictment, when one reads count 1 together with count 5. However, prior acts of individuals which are not directly related to the affairs of the corporation are not material, within the Section 14(a) context, as a matter of law. That is the teaching of *Levy;* and it is no answer to say that such actions reflect generally upon the character of the individuals standing for election. It is for this reason that count 4 of the indictment, relating to the TDA proxy solicitation, is deficient. None of the acts alleged in count 1 of the indictment relates to direct looting of TDA by any of the defendants. While the indictment charges certain defendants with manipulation of TDA common stock, and the acquisition and resale of certain shares of TDA stock in a manner that could certainly be regarded as fraudulent, the corporation's assets were not looted or depleted in any way. Purchasers of TDA common stock may have been defrauded; sellers of previously restricted TDA stock may have been defrauded; these transactions may very well cast certain of the defendants in an unflattering light; but the facts as pleaded by the Government do not give rise to a potential violation of Section 14(a) in respect of the TDA proxy solicitation.

Accordingly count 4 of the indictment is subject to dismissal on this alternative ground as well. Count 5 is, of course, dismissed for the reasons stated under Point I *supra.* If that determination should be reversed by higher authority, then count 5 will be sent to trial, with the guilt or innocence of each of the individual defendants named in that count to be resolved upon the trial.

III.

OTHER DISPOSITIVE MOTIONS

Various other contentions are made by the defendants in their motion papers. Those particular arguments, which I find to be mostly lacking in merit, are discussed below.

A. Multiple Conspiracies

Counsel for Fields and Friedman make the familiar—if not obligatory—motion to dismiss the conspiracy count for the reason that it avers multiple schemes. The present motion may be somewhat unorthodox, though, in that it has been made in advance of trial, whereas this ritual is generally observed after the Government has submitted its case in order that counsel may marshal facts indicating that the proof was indeed at variance with the averment of a single conspiracy.

Noting that the prosecution of activities which occurred prior to November 10, 1971 would be prohibited by the applicable five year statute of limitations, 18 U.S.C. § 3282, defendants contend that the indictment includes the Westcalind commission (paid in March, 1971) and the April and May, 1971 ERD kick-backs solely for the purpose of reviving them as actionable offenses. The six to eight month interval between said transactions and the public offering is cited as proof that those activities could not have been undertaken as part of a scheme whose intention was to defraud investors.

A fair reading of the indictment does not support this claim. A single conspiracy which employed two devices—the Zammas manipulation and the deficient prospectus—is alleged. The Westcalind "finders fee" and the ERD kick-

backs are not means to the accomplishment of the substantive crime, but simply facts whose omission from the November prospectus caused that document to work a fraud upon investors. In other words, the conspiracy consisted not in the plan to do those acts, but in the agreement to conceal them from purchasers of TDA stock at the public offering. Understood as such, the authority cited by defendants becomes plainly distinguishable, and the indictment neither "confusing", "difficult to understand" nor unlike many other conspiracy prosecutions which have been tried in this district, see *e.g., United States* v. *Aloi, supra* at 592, 599-600. Moreover, in a practical sense the exclusion of evidence concerning the ERD schemes as directed *supra* goes a long way towards alleviating this problem.

B. The Section 17 Violation (Count Two)

Counsel for Fields and Friedman attack the sufficiency of Count Two on the grounds that it fails to state with specificity the manner in which interstate commerce was used [11] to further the conspiracy and neglects to identify the person or persons defrauded. These contentions are without merit.

As regards the former, counsel express their dissatisfaction with the mere tracking of the statutory language of Section 17 as contained in paragraph nine of the indictment. No other specifics concerning the use of interstate facilities of commerce are set forth. However, the rule has long

[11] The argument is also raised in the context of the conspiracy charge. Since the Court holds that the averments regarding the use of interstate facilities are sufficient for purposes of the substantive count, they will perforce suffice for purposes of the conspiracy. *Wong Tai* v. *United States,* 273 U.S. 77, 81 (1927); *United States* v. *DeSapio,* 299 F.Supp. 436, 445 (S.D.N.Y. 1969) ("It is not necessary to describe the substantive offense which is the object of the conspiracy with the particularity required in an indictment for that offense.").

been established that an indictment will be deemed suitably detailed if it enables an accused to prepare a defense and to effectively raise the claim of double jeopardy in the event that a second prosecution, flowing from the same action, is initiated. *United States* v. *Debrow,* 346 U.S. 374 (1953); *Hagner* v. *United States,* 285 U.S. 427 (1932); *United States* v. *Cohen,* 518 F.2d 727 (2d Cir. 1975). This test is amply met by the elaborate pleading herein, which describes in depth the means and the objective of the alleged deception. The use of the mails or other instrumentality of interstate commerce is simply the jurisdictional predicate of this provision, and consequently the failure of the indictment to set forth the exact manner in which these facilities were used does not hinder the defendants' ability to prepare their defense to the merits of the charge. Moreover, unlike the mail fraud statute, 18 U.S.C. § 1341, each utilization of interstate means of commerce does not constitute a separate offense thereby raising potential double jeopardy complications.

United States v. *DeSapio,* 299 F.Supp. 436 (S.D.N.Y. 1969), relied upon extensively by movants, is wholly inapposite. In that case, defendants were charged with conspiring to violate 18 U.S.C. §§ 1951 (the Hobbs Act), 1952 (The Travel Act) and 1341 (the Mail Fraud statute). This last offense-object was pleaded in the bare-bones language of the statute and was wholly devoid of averments of the behavior which constituted the crime. Except by reference to another portion of the indictment, the use of the mails was not specifically averred. This defect was obviously fundamental, unlike that complained of herein, since the accused there were unable to prepare their defenses to the merits of the charge.

In passing on this issue Judge Metzner noted that even the actual use of the mails, which is the very gist of a Section 1341 violation, was not effectively pleaded:

> "The indictment does not even state whether the letter was placed in the mails, which is the essential element of mail fraud. The letter could have been hand-delivered, which is not an uncommon practice in this city." 299 F.Supp. at 446.

Plainly, this statement, made in the context of a mail fraud charge, cannot be made to stand for the proposition that the dates, places and contents of mailings must be set forth in a Section 17 prosecution.

Of course, the failure of the Government to demonstrate at trial that interstate commerce facilities were used to further the scheme would deprive this Court of jurisdiction over the offense and require dismissal of the charge. To the extent that this information is sought prior to trial, it may be procured through a proper demand for a bill of particulars. It need not be averred in detail in the indictment.

Similarly, Fields and Friedman contest the validity of count two because it fails to identify by name the victims of the securities fraud. This omission does not render the charge legally infirm; quite obviously the averred scheme was aimed at all purchasers of TDA common stock who invested in that company pursuant to the November 10, 1971 public offering. The fact that the individuals thus deceived are not set forth with particularity does not hamper the defendants' ability to meet the merits of the allegation, and further, it is not an impermissible abdication of the grand jury's duty nor an invitation to prosecutorial abuse, as was the case in *United States* v. *Agone,* 302 F. Supp. 1258 (S.D.N.Y. 1969).

There, the court dismissed an indictment charging extortion under the organized labor statutes, 29 U.S.C. §§ 530, 411(a)(2), on the ground that it failed to name the indi-

vidual threatened. With characteristic incisiveness, Judge Frankel noted that since there were a "substantial" number of potential targets of defendant's intimidation:

> "It has left the prosecution free to fill in this vital missing element—free, in a way which is constitutionally grave whether or not it is highly probable, to name someone different from the one intended by the grand jury. A prosecutorial power 'to roam at large' in this fashion is not allowable. [citation omitted]" 302 F.Supp. at 1261.

These considerations are patently irrelevant here, where the stock scheme, constituting a single offense, regardless of the number of victims, is set forth with a wealth of detail. Thus, unlike the situation in *United States* v. *Agone, supra,* the failure to include the names of the misled TDA investors is a matter of "pleading etiquette or esthetics", and not a concern touching upon "substantial rights of the most essential mind." 302 F.Supp. at 1259. See *e.g., United States* v. *Niedelman,* 356 F.Supp. 979, 982 (S.D.N.Y. 1973) (Mail Fraud); *United States* v. *Dorfman,* 335 F.Supp. 675, 679 (S.D.N.Y. 1971) (Wire Fraud). Needless to add, the lack of any proof at trial that the scheme was in connection with "the offer of sale" of securities will mandate dismissal of the charge for lack of subject matter jurisdiction.

C. The False Statement Violation (Count Three)

1. *Objection to Venue*

Defendant Davis moves to dismiss count three of the indictment for improper venue.

Count three alleges violation of the False Statement Act, 18 U.S.C. § 1001, which provides:

> "Whoever, in any matter within the jurisdiction of any department or agency of the United States

> knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined not more than $10,000 or imprisoned not more than five years, or both."

Within the context of the present case, the violation is alleged to consist of the omission from the prospectus filed with the SEC, covering the public sale of the TDA shares, of the matters set forth in count one.

Davis contends that venue can lie only in the District of Columbia, under the holding in *Travis* v. *United States,* 364 U.S. 631 (1961). In *Travis* a union official was indicted in the District of Colorado for violation of 18 U.S.C. § 1001. The false statement in question was contained in an affidavit, sworn to in Colorado, to the effect that Travis was not a communist. Travis mailed this affidavit to Washington for filing with the National Labor Relations Board, in order to trigger a representation investigation by the NLRB. Under the labor statute as it then read, no such investigation could be made "unless there is on file with the Board" such an affidavit. The Court reasoned from this language that until the filing of the affidavit was completed in Washington, there was no "matter within the jurisdiction" of the Board under 18 U.S.C. § 1001; and that in consequence venue lay in the District of Columbia but not in Washington. The case turned on narow facts, a decisive one being that the underlying statutory scheme did not *require* the filing of the affidavit. Thus the majority opinion observes:

> "Section 9(h) of the National Labor Relations Act, with which we are concerned, did not require union

> officers to file non-Communist affidavits. If it had, the whole process of filing, including the use of the mails, might logically be construed to constitute the offense. But this statutory design is different. It requires that the Board shall make no investigation nor issue any complaint in the matters described in § 9(h) 'unless there is on file with the Board' a non-Communist affidavit of each union officer. The filings are conditions precedent to a union's use of the Board's procedures." 364 U.S. at p. 635.

The particular facts in *Travis,* which arise out of the wording of an unusual statute, bear no meaningful resemblance to the case at bar. As the Government observes in its brief (p. 43), "defendants were required to file the prospectus, in order to make the public offering of stock." That is sufficient to distinguish *Travis,* which as the Second Circuit observed in *United States* v. *Slutsky,* 487 F.2d 832, 839 n. 8 (2d Cir. 1973), *cert. den.,* 416 U.S. 937 (1974) "was meant to be confined to the facts based on the unusual statute involved." That is a wholly appropriate observation, in view of the Supreme Court's language quoted *supra.*

Defendant's contention, if sound, would establish the United States District Court for the District of Columbia as the only forum in the nation where entrepreneurs, from all 50 states of the Union, submitting prospectuses in obedience to the securities laws, could be indicted under 18 U.S.C. § 1001 if the prospectuses are false. The contention is inherently unsound, and I reject it.

Venue is properly laid in "the whole area through which force propelled by an offender operates." *United States* v. *Johnson,* 323 U.S. 273, 275 (1944). That principle is codified in the "continuing offense" statute, 18 U.S.C. § 3237(a), under which an offense begun in one district and completed

in another, or committed in more than one district, may be prosecuted in any district in which such offense was "begun, continued or completed." The Second Circuit held that statute applicable to an 18 U.S.C. § 1001 violation in *United States* v. *Candella,* 487 F.2d 1223 (2d Cir.) *cert. den.,* 415 U.S. 977 (1974), in which false affidavits and bills of lading intended ultimately to generate HUD funds were prepared, executed and handed to city officials in Brooklyn for conveyance to a central office in Manhattan. The Second Circuit held that venue under the False Statement Act would be in either the Eastern or Southern District of New York:

> "18 U.S.C. § 1001 defines the offense as the making of a false or fraudulent statement or representation in a matter within the jurisdiction of a federal agency. The false statements here were intended to produce funds. The statements continued to be false and continued to be within the jurisdiction of the United States not only when initially presented but also upon arrival in Manhattan, where the decision was reached to make the funds available. See United States v. Kenofskey, 243 U.S. 440, 37 S.Ct. 438, 61 L.Ed. 836 (1917). Venue for all counts thus was properly laid in the Southern District of New York." 487 F.2d at 1228.

United States v. *Natelli,* 527 F.2d 311 (2d Cir. 1975), *cert. den.,* 425 U.S. 934 (1976), while not arising under the False Statement Act, is consistent with these general principles. Defendants were charged with false proxy statements in violation of 15 U.S.C. § 78ff(a). They contended that venue would lie only in the District of Columbia, where the proxy statements were filed. Reliance was placed on *Travis.* The Second Circuit, distinguishing *Travis,* held that venue was properly laid in the Southern District of New York:

"Appellant seeks to come within the Travis holding by arguing that just as in Travis where the filing of the non-Communist affidavit was simply a prerequisite to fu.ure conduct, resort to NLRB processes, so the filing of a proxy statement is merely the prerequisite to future conduct, the solicitation of proxies. The argument is unsound.

"In Travis, the labor board had no jurisdiction to make an investigation of labor practices 'unless there is on file with the Board' a non-Communist affidavit. Here the filing of the proxy statement is part of the continuous process of the solicitation of proxies. Proxy statements are filed only at such time as the persons filing require proxies for some corporate purpose. The filing and solicitations are part of the some process. We hold that there was venue in the Southern District of New York." 527 F.2d at 326-7.

The present defendant argues that a prospectus is so different in nature from a proxy statement that *Travis* should apply. I perceive no meaningful difference. The filing of a registration statement and prospectus is "part of the continuous process" of the solicitation of public funds, just as the filing of a proxy statement is part of the "continuous process of the solicitation of proxies." Furthermore, just as in *Candella, supra,* the allegedly false prospectus was "intended to produce funds." Unlike the non-communist affidavit in *Travis,* filing of the prospectus was required by the pertinent statute. *Travis* is inapplicable; the continuing offense statute *is* applicable; and the objection to venue is rejected.

2. *The Legal Sufficiency of Count Three*

Counsel for Fields and Friedman move to dismiss the false statement count on theory that it is too indefinitely

and vaguely pleaded. This shortcoming stems from the fact that the indictment does not set forth *de novo* the specific false statements or material omissions allegedly contained in the prospectus, but rather incorporates by reference the relevant facts averred in support of the conspiracy charge.

Defendants complain that as a result of this abbreviated type of accusation, they cannot make the necessary determination of which statements are deemed to be false in the prospectus. Resort to the "means" section of the conspiracy charge (paragraph 10) does not, to counsel's satisfaction, provide the required information. There, the Zammas manipulations (set forth in subparagraphs (a) through (c)) are not averred to have been deliberately omitted from the prospectus and cannot therefore be the basis of the false statement claim. The Westcalind and ERD transactions do not suffer from this infirmity; however, standing alone they still fail to supply requisite data. Citing the language of Section 17 as pleaded in the "object" section of the conspiracy charge (paragraph 9), defendants contend that count three does not designate which of the statements affirmatively made in the prospectus were made misleading by virtue of the concealment of the two kickback schemes. Apparently defendants' counsel construe a prosecution under 18 U.S.C. § 1001 for omissions to require, in the pleading, an indication of which representations actually made were rendered misleading in the light of the averred concealment, see *Spielman* v. *General Host,* 402 F.Supp. 190 (S.D.N.Y. 1975) (Weinfeld, J.)

This argument is admirable in its sophistry only, for the plain language of the statute utterly refutes any such interpretation. In prohibiting false statements accomplished through concealment or "cover-up", Section 1001

does not utilize any language comparable to that of Section 17, requiring actionable omissions to be such as to render "... the statements made, in the light of the circumstances under which they were made, not misleading."

Moreover, counsel's professions of ignorance of the matters charged under count three are indeed more feigned than real. Defendants have been apprised by this lengthy indictment of what facts the Government believes were impermissibly omitted from the prospectus; obviously, what was made deceptive by these concealments was the overall picture of TDA's true financial status as presented in the prospectus. Defendants' construction of the pleading requirements for 18 U.S.C. § 1001 would require in omission cases a line by line analysis of the offending document, with annotations on each of the statements made misleading by the undisclosed facts. Pleading of this complexity is not contemplated by the statute itself, nor by general standards of sufficiency mandated by constitutional concerns.

The cited language from *Spielman* v. *General Host, supra,* a case involving the materiality of omissions from exchange offer materials, cannot be contorted into requiring such specificity in a criminal proceeding under the false statement provision. That case simply does not speak to the question of the sufficiency of indictments for Section 1001 violations, and as such does not bolster counsel's position.[12]

[12] This motion also advances the qualified theory that the false statement provision encompasses only actual misstatements and not failures to speak.

> "... [T]hese alleged omissions from the prospectus cannot as a matter of law be the type or kind of false, factitious (sic) and fraudulent representations outlawed by Section 1001", Main Memorandum submitted on behalf of Fields and Friedman at 37.

(footnote continued on following page)

D. Sufficiency of the Use of the Mails with Respect to Counts 7-10

Counsel for Sandberg has moved to dismiss counts 7 through 10, invoking the "Kreisler kick-back" described *supra,* on the ground that said transaction lacked a sufficient nexus with the mails to sustain federal jurisdiction. The memorandum of law submitted on behalf of this defendant in support of the motion portrays the letters in question as "pro forma opinion letters" relevant to Sandberg's purchase of TDA stock, allegedly funded by his share of the Kreisler kickback. Assuming the truth of these assertions, defendant's counsel urges that this investment, and its related correspondence, was too remote from the fraudulent transaction averred to come within the purview of 18 U.S.C. § 1341.

This argument may prove to be well-founded; however, there are not presently before the Court sufficient facts to make such a determination. The indictment does state that the mailings were "for the purpose of executing or attempting to execute" the scheme, and by virtue of that declaration, the Government is entitled to submit evidence necessary to support such a claim. It may be that defendant's characterization of the correspondence is accurate and

This contention is frivolous and is unsupported by *United States* v. *Adcock,* 447 F.2d 1337 (2d Cir.), *cert. den.,* 404 U.S. 939 (1971). There, defendant was prosecuted under this section for having filled out an alien's immigration form and allowing the alien to sign it thereby creating the mistaken impression as to the actual author of the responses. The case was premised on the position that defendant had in this manner caused a false statement to be made. Noting that "Nowhere does the form contain any assertion by the applicant that he himself prepared the form," 447 F.2d at 1338, the Second Circuit reversed the conviction on the ground that no statement whatsoever had been made. The case can hardly be said to stand for the proposition that certain kinds of omissions cannot be prosecuted under the false statement statute.

that such mailings were incidental to a transaction which itself was wholly collateral to the Kreisler kickback scheme, thereby requiring dismissal, compare *United States* v. *Brown*, F.2d (2d Cir. May 16, 1977) (Dkt. No. 77-1033) with *Gordon* v. *United States*, 358 F.2d 112 (5th Cir. 1966). Such a decision must await submission of the Government's case.

IV.

MOTIONS FOR SEVERANCE

Applications have been made to sever certain counts and individuals from the trial of the indictment. In the event that these matters do come before the Court, they are disposed of as follows.

The motion to sever counts 6 through 11, unopposed by the Government, is granted.

Defendant Berge has moved for a severance based upon his alleged physical incapacity to travel from his California domicile to New York, and to withstand the stress of trial, as attested to by the statements of physicians who examined him.

The Government opposes the granting of such relief at this time. Instead, the Government asks this Court to direct that a physician selected by the Government be sent from New York to California for the purpose of examining Mr. Berge, and thereafter forwarding his opinion to the Court and counsel as to whether or not Mr. Berge is fit to come to New York for trial.

For the reasons that will appear in the following discussion, the Court grants at this time Mr. Berge's motion for severance on the basis of ill health. The Court bases its action upon the medical evidence presently before it.

Among other letters, there has been submitted to the Court a letter dated December 7, 1976, from Harold Lovitz, M.D., of Encino, California. Dr. Lovitz has been Mr.

Berge's personal physician since 1960. Dr. Lovitz states that Mr. Berge developed serious hypertension in 1972; that in an examination on November 30, 1976, this condition was found to have worsened significantly; and that, in respect of Mr. Berge's condition on December 7, 1976:

> "Mr. Berge suffers from severe hypertension that is aggravated by emotional stress or trauma. For this reason, I am of the opinion that any court proceedings involving this patient would place his health and indeed his life in the greatest jeopardy. The stress entailed in the preparation for trial, examination and cross-examination, and the mere appearance in court would precipitate a cerebro-vascular accident resulting in disability and even death."

In support of his application, Mr. Berge has also submitted a letter dated April 4, 1977 from Stanley S. Franklind, M.D. of Los Angeles. Dr. Franklind first examined Mr. Berge on March 7, 1977, at which time blood pressure values as high as 216/124 were obtained. Mr. Berge was hospitalized for observation and tests for one week beginning on March 25; Dr. Franklind states that further hospitalization for additional tests and possible thyroid surgery are contemplated in about one month. Dr. Franklind expresses his opinion that "Mr. Berge is in no condition to either travel or participate in any legal proceedings for a minimum of three months."

These medical opinions, which as noted were obtained by Mr. Berge, were made known to counsel for the Government. There then ensued a dialogue between counsel for Mr. Berge and for the Government, with a view towards having Mr. Berge examined by a ''neutral'' physician. According to the statements of counsel made in open court on April 14, 1977, counsel for Mr. Berge submitted a list of five physicians to counsel for the Government; none of these

was acceptable to the Government; the Government then proposed a physician to counsel for Mr. Berge, who was in turn rejected. Eventually, however, as the result of conversations between the office of the United States Attorney and medical authorities at the Cedars of Lebanon medical facility in California, Louis S. Fishman, M.D. of Beverly Hills, California was selected to make a further examination of Mr. Berge. Mr. Fishman, a diplomate of the American Board of Internal Medicine, was acceptable to counsel for Mr. Berge. In accordance with this agreement of counsel, Dr. Fishman examined Mr. Berge on March 17. Dr. Fishman's report, in a letter of March 23, 1977, recites his findings of "extreme hypertension, complicated by and contributed to by a severe physiological anxiety reaction", complicated by "serious cardiac arrhythmia", resulting from a combination of "organic cardiac disease and stress." Dr. Fishman's report concludes:

> "In my opinion Mr. Berge should be hospitalized for diagnosis and treatment of the above conditions. Medically I do not feel that he should travel out of this city. I am fearful of life threatening cardica (sic) or cerebrovascular complications should he be subjected to travel and especially stressful situations such as one might experience in a court proceeding."

While counsel have not submitted to the Court an order in respect of Dr. Fishman's appointment prior to his examination of Mr. Berge on March 17, such an order was handed up at the hearing on April 14. That order, which should be regarded as taking effect *nunc pro tunc* provides *inter alia* for the the examination by Dr. Fishman of Mr. Berge on March 17, pursuant to Rule 706 of the Federal Rules of Evidence; and for the compensation of Dr. Fishman by the United States Attorney for the Southern District of New York.

In these circumstances, I do not hesitate to regard Dr. Fishman as a court-appointed physician; and I see no reason for the further examination which the Government requested at the hearing on April 14.

All physicians who have examined Mr. Berge concur that, in the present state of his health, he should not attempt to undergo the stress of travel or trial. I accept these medical findings and recommendations, and accordingly direct a severance of Mr. Berge from the trial. The resulting period of delay, in respect of Mr. Berge, constitutes excludable time within the context of the Speedy Trial Act. 18 U.S.C. § 3161(h)(4).

Counsel for the parties are directed further to advise the Court in respect of Mr. Berge's physical condition not later than 120 days from the date of this opinion.

CONCLUSION

For the foregoing reasons, this Court has issued an order stating as follows:

1. The Securities and Exchange Commission having breached a duty to defendants which required them to disclose the fact of its having made a criminal reference of this matter prior to the defendants entering into a civil consent judgment with said agency, paragraphs 10(d) through 10(h) and 11(e) of the indictment which relate to transactions and matters specifically referred to in said settlement, are hereby stricken, in the exercise of the Court's supervisory powers.

2. In consequence of this ruling, counts four through eleven of this indictment are dismissed in their entireties.

3. In further consequence of this ruling, the indictment as to defendants Frederick M. Friedman, Peter S. Davis and Alan E. Sandberg is dismissed.

4. As an alternative basis for dismissal, those portions of counts one through three of the indictment relating to the ERD transactions, described in paragraphs 10(f) through 10(h) of the indictment, are dismissed for failure to state an offense.

5. As an alternative basis for dismissal, count four of the indictment is dismissed for failure to state an offense.

6. Counts six through eleven of the indictment are severed from the trial in any event with the consent of all parties.

7. Defendant Eric Berge is severed from trial of this action for medical reasons, pursuant to the Court's findings with respect to his physical condition reached following a hearing previously held.

8. Trial of Douglas P. Fields on the manipulation of the price of TDA stock averred in paragraphs 10(a) through 10(c) of the indictment will commence on May 31, 1977 at 10:00 a.m., or as further ordered by the Court.[13]

9. Trial of Eric Berge on count twelve of the indictment will take place at a date and time to be fixed by further order of this Court.

10. All other motions are denied.

Dated: New York, New York
June 2, 1977

/s/ Charles S. Haight, Jr.
CHARLES S. HAIGHT, JR.
U. S. D. J.

[13] Subsequent to the issuance of that order, the Court on consent stayed the trial pending resolution of a possible interlocutory appeal from the order.

APPENDIX B

United States of America v. Fields, et al.

United States District Court, Southern District of New York. 76 Cr. 1022-CSH. July 7, 1977.

HAIGHT, District Judge: The Government has moved for rehearing and reconsideration of two aspects of the Court's prior opinion of June 2, 1977 and implementing order, entered in response to defendants' motion to dismiss the indictment. While defendants attack the Government's motion, and its supporting documents, on technical grounds, I shall consider it on the merits. For the reasons stated below, the motion for rehearing is granted; and the Court, upon consideration, adheres to its prior opinion and order.

I.

In its prior opinion and order, the Court struck paragraphs 10(d) through 10(h) and 11(e) of the indictment, and struck counts four through eleven, on the ground (as the Government accurately states in its motion) that the SEC breached a duty to disclose to defendants the criminal reference it had made to the United States Attorney's Office. The Government now contends—as it did during the hearings and in its original briefs—that the appropriate remedy lies in vacating the civil consent judgment, while permitting the criminal indictment to go to trial.

I carefully considered that alternative in formulating the prior opinion and order. I rejected it then, for reasons previously stated and not here reiterated. In essence, I do not regard vacatur of the civil judgment as an adequate remedy in the circumstances of the case, in respect of either the defendants' position or the necessary prophylactic effect upon the SEC.

The Government advises the Court, in support of its present motion, that the SEC "is prepared to seek to vacate the injunction and ancillary relief obtained therein", *provided* that the Court determines that "the appropriate alternative remedy in the case would be directed towards the civil relief obtained by the Commission" (affidavit of David A. Cutner, Esq., at p. 2, quoting representation of Wallace Timmany, Assistant Director of the Division of Enforcement, SEC). But since the Court declines to make the threshold determination, the SEC's state of preparation has no office to perform.

Mr. Timmany also represents that, on the basis of the Court's prior findings, "the Commission has undertaken an independent inquiry in this matter at the conclusion of which the Commission will take all actions which it deems appropriate." I am gratified, if not surprised, by this intelligence; it is an appropriate response to the Court's findings; but it does not relieve me of my responsibilities within the context of the case before me. I remain of the view that, in the circumstances of the case, dismissal of the indicated portions of the indictment is the proper remedy.

II.

The Government also urges reconsideration of the alternative ground for dismissal of count 4 of the indictment which charged violation of the proxy solicitation statute, 15 U. S. C. § 78(n), and Rule 14a-9 promulgated thereunder, 240 C. F. R. § 14a-9, in that the defendants' averred theft from Westcalind Corporation ("Westcalind"), a company in which TDA Ind., Inc. ("TDA") held 34% of the voting stock, was not disclosed. As previously discussed, the principal subject of that solicitation was the re-election

of certain defendants, charged with involvement in the "Westcalind kickback", to the board of directors of TDA.

This Court based its prior ruling on the rationale of *Securities and Exchange Comm.* v. *Kalvex, Inc.*, 425 F. Supp. 310 (S. D. N. Y.) 1975), and *Levy* v. *Johnson,*— F. Supp.—(S. D. N. Y. Feb. 16, 1977) (Dkt. No. 76 Civ. 1178-RO), wherein Judge Owen held that the proxy solicitation regulations do not require disclosure of a directorship candidate's peculations, if those activities were not practiced upon the corporation to whose board he is seeking election. The papers submitted to the Court in support of the motion for reargument purport to demonstrate that the relationship between TDA and Westcalind was such that an embezzlement from the latter was tantamount to a theft from the former, and that consequently, the TDA proxy solicitation was deficient in failing to reveal the $50,000 swindle averred in count 4 of the indictment.

While the issue is not entirely free from doubt, this aspect of the motion must also be denied for the reason that the Westcalind kick-back was too far removed from the subject of the TDA solicitation to have improperly influenced the shareholders' actions.

Thus, it should be noted that Westcalind's operations were not consolidated with TDA's for financial reporting purposes; indeed, under pertinent authority, consolidation would have been improper since TDA owned less than a majority of Westcalind's outstanding stock, see Regulation S-X, 17 C. F. R. § 210. TDA's investment in Westcalind was reflected in its annual report as an "asset", just as was its ownership of other stocks or bonds. Therefore, the kickback could have influenced the TDA solicitation only if the theft was of such magnitude that it caused Westcalind's financial condition to be substantially overstated,

thereby causing its stock to be overvalued, thereby causing TDA's "assets" figure in the annual report to be inflated, thereby causing TDA's shareholders to be misled as to the condition of their company under the leadership of the individuals standing for election. However, this kind of potential impact is too remote and speculative a ground on which to predicate a criminal violation of the proxy solicitation regulations because the required "transaction causation" is absent. The Court therefore holds that the facts of the instant case do not come within the perimeters of *SEC* v. *Kalvex, supra;* rather, the disposition is controlled by *Levy* v. *Johnson, supra.* See also *Lewis* v. *Elam,* CCH F. Sec. L. Rep. ¶ 96,013 (S. D. N. Y. April 5, 1977).

Accordingly, the motion for reargument is, in all respects, denied.

It is So Ordered.

APPENDIX C*

UNITED STATES COURT OF APPEALS

For the Second Circuit

No. 342—September Term, 1977.

(Argued November 16, 1977;
finally submitted January 11, 1978

Decided September 14, 1978.)

United States of America,

Appellant,

—v.—

Douglas P. Fields, Frederick M. Friedman, Peter S. Davis, Alan E. Sandberg, and Eric Berge,

Defendants-Appellees.

Before:

Feinberg, Mansfield and Timbers,

Circuit Judges.

Appeal by the United States from an order entered in a *criminal* action prior to trial in the Southern District of New York, Charles S. Haight, Jr., *District Judge,* [Current] CCH Fed. Sec. L. Rep. ¶ 96,074 (S.D.N.Y., June 2, 1977), which dismissed and struck substantial portions of a securities fraud indictment because of alleged misconduct by SEC employees in attempting to settle a *civil* action brought by the SEC against defendants who later were named as defendants in the criminal action.

Affirmed in part; reversed and remanded in part, with directions to reinstate the unexpurgated indictment.

* For the convenience of the Supreme Court, the opinion of the United States Court of Appeals is herewith set out in its original [original] and corrected (corrected) form. (See App. D, p. 106a-109a).

David A. Cutner, Asst. U.S. Atty., New York, N.Y. (Robert B. Fiske, Jr., U.S. Atty., and Lawrence B. Pedowitz, Asst. U.S. Atty., New York, N.Y., on the brief), *for appellant United States.*

Louis Bender and Sandor Frankel, New York, N.Y., *for defendants-appellees Fields and Friedman.*

Gary P. Naftalis, New York, N.Y. (Sheldon H. Elsen, Leslie A. Lupert, Gary H. Greenberg, and Orans, Elsen & Polstein, New York, N.Y., on the brief), *for defendant-appellee Davis.*

Norman S. Ostrow, New York, N.Y. (Frank H. Wright, and Grand & Ostrow, New York, N.Y., on the brief), *for defendant-appellee Sandberg.*

Hochman, Salkin and DeRoy, and Stephen V. Wilson, Beverly Hills, Calif., filed a brief *for defendant-appellee Berge.*

Harvey L. Pitt, General Counsel, Paul Gonson, Assoc. General Counsel, Irving H. Picard, Asst. General Counsel, and Lawrence A. Horn, Atty., SEC, Washington, D.C., filed a brief *for Securities and Exchange Commission, amicus curiae.*

Timbers, Circuit Judge:

On this appeal by the United States [1] from an order entered in a *criminal* action prior to trial in the Southern District of New York, Charles S. Haight, Jr., *District Judge,* [Current] CCH Fed. Sec. L. Rep. ¶ 96,074 (S.D. N.Y., June 2, 1977), which dismissed and struck substantial portions of a securities fraud indictment because of alleged misconduct by SEC employees in attempting to settle a *civil* action brought by the SEC against defendants who later were named as defendants in the criminal action, the chief question is whether the district court abused its discretion.[2] We hold that it did.

We affirm in part, and reverse and remand in part, with directions to reinstate the unexpurgated indictment and to proceed with the case in the district court according to law.

I.

The indictment which is the subject of the instant appeal was returned November 8, 1976. It named as defendants, all of whom are appellants herein, Douglas P. Fields, Frederick M. Friedman, Peter S. Davis, Alan E. Sandberg, and Eric Berge. The specific offenses charged against the respective defendants are summarized in the margin.[3]

[1] The appeal is authorized by 18 U.S.C. § 3731 (1976). See *United States* v. *Alberti,* 568 F.2d 617, 620-23 (2 Cir. 1977), cited with approval, *Sanabria* v. *United States,* —— U.S. ——, —— n. 23 (1978), 46 U.S.L.W. 4646, 4650 n. 23 (U.S. June 14, 1978).

[2] Other subordinate questions are presented, as will appear below in this opinion.

[3]

Count	*Defendant*	*Violation*	*Statute*
One	Fields, Friedman, Davis	Conspiracy to violate securities laws	18 U.S.C. § 371

(footnote continued on following page)

To the extent necessary to an understanding of our rulings on the legal issues presented, we summarize here the essential facts and fraudulent transactions charged in the indictment.[4] They occurred during the two year period from March 1971 to March 1973. They involved two publicly held corporations, TDA Industries, Inc. (TDA) and its subsidiary, Westcalind Corp. (Westcalind). Defendants were officers and directors of the two corporations, except that Davis, an attorney, was general counsel to TDA.

(A) *Westcalind Kickback*

In March 1971, while Fields and Friedman were officers and directors of TDA, they caused Westcalind to pay a

Count	*Defendant*	*Violation*	*Statute*
Two	Fields, Friedman, Davis	Securities fraud	15 U.S.C. § 77q(a)
Three	Fields, Friedman, Davis	Filing false prospectus with the SEC	18 U.S.C. § 1001
Four	Fields, Friedman, Davis	Soliciting proxies with false proxy statements	15 U.S.C. § 78n(a)
Five	Fields, Friedman, Berge, Davis	Soliciting proxies with false proxy statements	15 U.S.C. § 78n(a)
Six	Friedman, Sandberg	Wire Fraud	18 U.S.C. § 1343
Seven-Ten	Friedman, Sandberg	Mail Fraud	18 U.S.C. § 1341
Eleven	Friedman	Soliciting proxies with false proxy statements	15 U.S.C. § 78n(a)
Twelve	Berge	False testimony before the SEC	18 U.S.C. § 1001

[4] We emphasize that our summary is of facts and transactions *charged* in the indictment. Each defendant, having pleaded not guilty, is presumed innocent unless and until convicted.

$50,000 "finder's fee" to a third party for services never performed. The "finder" retained $15,000 and kicked back the $35,000 balance to Fields and Friedman.

(B) *ERD Kickbacks*

In April and May 1971, Friedman and Davis refused requests by a group of TDA shareholders to "free-up" their lettered stock for public sale. These defendants falsely represented to the stockholders that the stock in question could be transferred only by a private placement. They then arranged for a private placement of the stock to themselves at a $2 per share discount from the market price. As soon as they acquired the stock, and by a prearrangement not disclosed to the selling stockholders, they did "free-up" the stock and sold it on the open market. Seventy percent of the gross profit was kicked back to these defendants, resulting in a profit to them in excess of $300,000. This transaction defrauded the selling TDA stockholders of $435,000.

(C) *Manipulation of Price of TDA Stock*

In November 1971, Fields paid certain co-conspirators to buy TDA stock on the open market immediately prior to a public secondary offering of the stock. This was intended artificially to inflate the offering price.

(D) *Eagle Roofing Kickback*

In February and March 1973, Friedman and Sandberg, each of whom was an officer and director of TDA, caused TDA to pay another sham "finder's fee", this time in amount of $100,000, to another third party for services never performed. The "finder" retained $18,000 and kicked back $82,000 balance to Friedman and Sandberg.

(E) *Other Offenses Charged*

In addition to the four transactions referred to above, the indictment charges the following other offenses:

Fields, Friedman and Davis prepared and filed an offering prospectus for TDA stock which failed to disclose the Westcalind kickback, the ERD kickbacks and the TDA price manipulation. They also solicited proxies from TDA stockholders without disclosing these matters in the proxy statements.

Fields, Friedman, Davis and Berge (the latter an officer and director of Westcalind) solicited proxies from Westcalind shareholders without disclosure of the Westcalind kickback, the ERD kickbacks and the TDA price manipulation.

Friedman and Sandberg violated the wire fraud and mail fraud statutes in connection with the Eagle Roofing kickback.

Berge gave false testimony under oath before the SEC about the Westcalind kickback.

Reiterating what we have said above, note 4 *supra,* the foregoing summary is of offenses *charged* in the indictment, not a summary of crimes proven. Nevertheless, for the purpose of evaluating the action of the district court in dismissing and striking substantial portions of the indictment and to understand our rulings on the legal issues presented, suffice it to say that the indictment charges each of the defendants with very serious offenses which, if proven, constituted a clear fraud on public investors.

II.

We focus next on the sequence of events during 1974 and 1975—chiefly, certain negotiations between counsel for defendants and employees of the SEC's New York re-

gional office—upon which the district court based its order dismissing and striking substantial portions of the indictment.[5]

Backing up for a moment, during 1974 and early 1975 the office of the District Attorney for New York County conducted an investigation of the Westcalind, ERD and Eagle Roofing kickbacks referred to above. The targets of this investigation were Fields, Friedman and Davis (represented by attorneys Milton S. Gould, Esq. and Saul S. Streit, Esq.) and TDA (represented by attorney Herbert C. Kantor, Esq.).

On January 9, 1975, Gould and Streit were informed by Assistant District Attorney Driscoll that his office had concluded that the three kickback transactions were not offenses cognizable under New York law. On the following day, January 10, anticipating that the District Attorney's office would refer the matter to the SEC's New York regional office, Gould telephoned William Moran, Esq., the SEC's New York regional administrator, and made an appointment to see him on January 14. Before telephoning Moran, Gould had advised Fields, Friedman and Davis that it would be preferable to take the initiative and bring the matter to the attention of the SEC before the District Attorney's office did. His clients agreed and authorized Gould to make

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[5] In ruling as we do on the chief legal question presented—that the district court abused its discretion in dismissing substantial portions of the indictment—we accept the district court's findings of fact on that issue. In short, we assume, without deciding, the correctness of the district court's findings.

While we disagree with the conclusions reached by Judge Haight, we have found his comprehensive eighty-two page opinion to be helpful in setting forth the evidence adduced during the eleven day hearing before him. And we have found especially commendable his candor in evaluating the testimony and acknowledging that his findings hinged on close questions of credibility.

the necessary disclosures to the SEC. Kantor received similar authority from the TDA board.

On January 14, Gould (representing Fields, Friedman and Davis) and Kantor (representing TDA) met in the SEC's New York regional office with Moran and members of his staff, including Jeffrey Tucker, Esq., a branch chief, and Stuart Perlmutter, Esq., a staff attorney. At this meeting Gould and Kantor disclosed to the SEC employees the three kickback transactions which had been under investigation by the District Attorney's office. They did not disclose to the SEC then, or at any other time, the scheme to manipulate the price of TDA stock referred to above. The upshot of the January 14 meeting was that Gould proposed negotiations looking toward a possible civil settlement of the transactions disclosed, on the assumption that the SEC's investigation would not turn up something new. Moran said that he first would have to obtain authorization from the SEC's Division of Enforcement for a formal investigation of the alleged *civil* violations. Such authorization was granted on February 19.

The chief purpose of the disclosures which defendants' counsel made at the January 14 meeting was to avoid a criminal reference to the Department of Justice.[6] Defendants' counsel, being thoroughly experienced in SEC procedure and in criminal matters, recognized from the outset that defendants' activities constituted criminal offenses under the federal securities laws. Their best hope, so they urged, was to work out some sort of a package by which defendants would accept the imposition of civil sanctions in return for the avoidance of a criminal reference. Defendants' experienced counsel of course also were aware of

[6] See discussion at pp. 4727-4732 *infra* regarding the SEC's criminal reference procedure, both formal and informal references.

the SEC's long standing and well known policy *against* settling civil actions in a manner that would impair subsequent criminal prosecutions.

As a result of the SEC's investigation which had been authorized on February 19 and after a number of conversations between defendants' counsel and the SEC employees regarding a possible civil settlement, the SEC commenced a civil action on September 16, 1975 in the Southern District of New York, entitled *SEC* v. *TDA Industries, Inc., et al.*, 75 Civ. 4519-LWP. The complaint named as defendants TDA, Westcalind and the five individual defendants later charged in the instant indictment. The complaint was based on the three kickback transactions which Gould and Kantor disclosed to the SEC at the January 14 meeting. The complaint sought injunctive and other relief, including an order that defendants disgorge the fraudulently obtained "finders fees" and the appointment of receivers for the two corporate defendants.

During settlement negotiations between defendants' counsel and the SEC employees, both before and after the commencement of the SEC civil action on September 16,[7] defendants' counsel repeatedly stated their desire to avoid a criminal reference if a consent judgment could be worked out in the civil proceedings.

Throughout these negotiations Tucker and Perlmutter of the SEC were aware of the stated objective of defense counsel to avoid a criminal reference if a consent judgment could be agreed upon. Tucker and Perlmutter remained silent during this period in response to the state-

[7] Such negotiations took place on February 28, June 17, September 4, September 30 and October 20. At the latter two meetings, defendants' counsel stated their understanding that an agreement had been reached that no criminal reference would be made.

ments of defense counsel as to their objective. Such silence was interpreted by defense counsel as assent by Tucker and Perlmutter to defense counsel's proposal to avoid a criminal reference. Nevertheless, as we state below, Tucker and Perlmutter were in touch with the United States Attorney's office as early as September 16 on the subject of a prospective criminal reference of the TDA matter.

As for the negotiations to settle the civil action, on December 1 a settlement offer was made by Gould and Streit to Tucker and Perlmutter, both of whom viewed the offer favorably. They recommended to their superiors that it be accepted. It was. Consents to the entry of judgment in the civil action were signed by Fields, Friedman and Davis on December 10 and 11, and judgments in the action as to them were entered on February 5, 1976. Similar consents were signed by Sandberg and Berge on January 6 and February 10, and judgments as to them were entered on January 16 and February 23. None of the defendants or their counsel knew, when the consents to the entry of judgment in the civil action were signed, that [Tucker had made an informal criminal reference of the TDA matter to the United States Attorney's office on December 1, as stated below.] <u>Tucker had communicated with the United States Attorney's office concerning the TDA matter on December 1, as stated below.</u>

As indicated above, Tucker and Perlmutter, beginning in September 1975, had been in touch with the United States Attorney's office about a criminal reference of the TDA matter. These contacts with Assistant United States Attorney Sorkin[8] continued during October and November.

[8] Not to be confused with Stanley Sporkin, Esq., Director of the SEC's Division of Enforcement, who testified before Judge Haight on this matter.

During this period Tucker and Perlmutter urged the United States Attorney's office to investigate the TDA matter but they made it clear that they wanted to conclude a settlement in the civil action before making a criminal reference.

On December 1, shortly after Gould and Streit had made the offer to settle the civil action, Tucker, in the presence of the Assistant Regional Administrator of the SEC's New York Regional Office, [made an informal criminal reference of the TDA matter to Assistant United States Attorney Wing] <u>communicated regarding the TDA matter with Assistant United States Attorney Wing,</u> Chief of the Fraud Unit of the United States Attorney's office. This was done by telephone, followed by a letter dated December 1 from Tucker to Wing enclosing the SEC's pleadings file in the TDA case.

There followed an investigation of the TDA matter by the United States Attorney's office, presentation of the case to a grand jury, and the return of the instant indictment on November 8, 1976.

III.

Before getting to the chief issue on this appeal as stated above, we shall take up as a preliminary matter the claim asserted by some of the appellees, namely, that [the informal criminal reference of this case by the SEC to the United States Attorney's office] <u>the communications regarding this case by the Commission's staff to the United States Attorney's office</u> on December 1, 1975 was contrary to the applicable statutes, rules and regulations. This ground for dismissal of the indictment[9] was urged upon the district

[9] This alternative ground for dismissal of the indictment, urged by some but not all of the appellees, should not be confused with the alternative grounds for dismissal of portions of the indictment which we discuss below under section V of this opinion. The district court sustained appellees' alternative grounds for dismissal referred to in section V; it rejected the alternative ground discussed here.

court, as it is upon us. The district court rejected it. We also reject it.

The claim in essence is that the statutes authorize only the "Commission" to transmit evidence to the Attorney General for criminal proceedings, and that therefore the informal criminal reference on December 1, 1975 by the SEC's New York regional office to the United States Attorney's office "constituted an invalid criminal reference requiring dismissal of the resulting indictment".[10] We hold that this claim is totally without merit.

[It is important to bear in mind the distinctions, under SEC procedure, between an *informal investigation* (such as that here involved) and a *formal investigation;* and between an *informal criminal reference* (such as that here involved) and a *formal criminal reference.*[11]] It is important to bear in mind the distinctions, under SEC procedure, between preliminary communications between the Commission's staff and the United States Attorney's office, which may occur in the context of either a formal or informal investigation, and Commission criminal references, which may in turn be either formal or informal.[11]

With respect to the investigation procedure, the *informal,* or *preliminary, investigation* [which was utilized in

[10] Brief of Appellee Sandberg, filed January 6, 1978, at 7. Substantially the same claim is adopted by some of the other appellees.

[11] These important distinctions are clearly and concisely set forth in the SEC's amicus curiae memorandum which was filed in this case at our request after oral argument. We requested the amicus memorandum because of the confusion on this matter which was evident in the briefs and oral argument of appellees' counsel.

The SEC procedure, with respect to both *investigations* and *criminal references,* also was explained in detail by Stanley Sporkin, Esq., Director of the SEC's Division of Enforcement, at the hearings before Judge Haight who referred to Mr. Sporkin's testimony in ruling as he did on this issue.

the instant case] does not require members of the staff to obtain Commission authorization before turning over public or nonpublic investigative materials to the United States Attorney's office. On the other hand, a *formal investigation* of alleged criminal violations [(not utilized here)], where issuance of process or compulsion of testimony is necessary, does require Commission authorization. A formal investigation may or may not be preceded by an informal or preliminary one. 17 C.F.R. § 202.5(a) (1977).[12]

As for the criminal reference procedure, whether formal or informal, it is authorized by statute and by Commission rules and regulations. In view of the fraudulent transactions charged in the instant indictment, we look to the Securties Act of 1933 [13] and the Securities Exchange Act of 1934,[14] each of which provides the statutory authorization

[12] C.F.R. § 202.5(a) (1977) in relevant part provides:

> "Where, from complaints received from members of the public, communications from Federal or State agencies, examination of filings made with the Commission, or otherwise, it appears that there may be violation of the acts administered by the Commission or the rules or regulations thereunder, a preliminary investigation is generally made. In such preliminary investigation no process is issued or testimony compelled. When it appears from information obtained either with or without a preliminary investigation that there is a likelihood that a violation has been or is about to be committed and that the issuance of process may be necessary, the matter is reported to the Commission, which may then order a formal investigation or examination, if it is deemed necessary. . . ."

[13] Section 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976), in relevant part provides:

> "The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this subchapter. . . ."

[14] Section 21(d) of the 1934 Act, 15 U.S.C. § 78u(d) (1976), in relevant part provides:

(footnote continued on following page)

for the Commission to transmit to the Attorney General available evidence of violations of the statutes involved for possible criminal proceedings.[15] Moreover, the Commission is authorized by statute to delegate "any of its functions" to an employee, among others.[16] In its Manual of Administrative Regulations, the Commission has delegated its authority to act to Directors of Divisions and Regional Administrators, and further has empowered these officials to redelegate such authority to designated members of their respective staffs.[17] The Commission's Manual

"The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this chapter or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter."

[15] The other statutes administered by the Commission contain similar provisions authorizing the Commission to make criminal references to the Attorney General. *See, e.g.*, Section 18(f) of the Public Utility Holding Company Act, 15 U.S.C. § 79r(f) (1976); Section 321(a) of the Trust Indenture Act, 15 U.S.C. § 77uuu(a) (1976); Section 42(e) of the Investment Company Act, 15 U.S.C. § 80a-41(e) (1976); and Section 209(e) of the Investment Advisers Act, 15 U.S.C. § 80(b)-9(e) (1976)

[16] 15 U.S.C. § 78d-1(a) (1976) in relevant part provides:

"In addition to its existing authority, the Securities and Exchange Commission, hereinafter referred to as the 'Commission', shall have the authority to delegate, by published order or rule, any of its functions to a division of the Commission, an individual Commissioner, a hearing examiner, or an employee or employee board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter: . . . ."

This statute, although codified as indicated, is not part of the Securities Exchange Act of 1934. It was enacted as Section 1 of the Act of Aug. 20, 1967, Pub. L. 87-592, 76 Stat. 394.

[17] Section 171.02A of the Commission's Manual of Administrative Regulations provides:

(footnote continued on following page)

specifically authorizes and *encourages* the disclosure of non-public information to other federal law enforcement officials even when it has been developed in other than a formal investigation.[18]

The district court below found that during recent years it has been the SEC policy in the Southern District of New York for the Regional Administrator to redelegate his authority to lower echelon attorneys for the purpose of conferring with the United States Attorney's office [at an early stage of an invesitgation, that is, during an informal or preliminary investigation] <u>at an early stage of either a formal or informal investigation.</u> [In the instant case, the

"Section 171: Cooperation With Federal, State and Foreign Government Authorities and With Self-Regulatory Organization.

171.02 *Responsibility and Redelegation.*

A. Authority to act in matters covered in this Section is hereby delegated by the Commission to Directors of Divisions and Regional Administrators having cognizance over cases in which cooperation with other Federal, State or foreign authorities or self-regulatory organizations is in the public interest. These Commission officials may redelegate authority to act to designated members of their staffs."

[18] Sections 171.06 and 171.07 of the Commission's Manual provide:

"171.06 *Cooperation With Other Federal Law Enforcement Authorities.* Since Commission cases frequently involve violations of the mail fraud statute and may involve other Federal statutes, *the Commission recommends and encourages full cooperation with* inspectors of the United States Post Office Department and other *Federal law enforcement officials. Commission officials are authorized in their discretion to make information developed in the course of their investigations,* other than formal investigations which have been ordered by the Commission, and other non-public information *available to these officials and to render such investigative assistance as may be required.*" (emphasis added).

(footnote continued on following page)

SEC investigation never proceeded beyond the preliminary stage. Moreover, the criminal reference on December 1, 1975 was an informal one. Both were fully and specifically authorized by the statutes and the Commission's rules and regulations.] We hold that the district court correctly declined to dismiss the indictment on this ground.

[As the SEC points out in its amicus brief, the procedure involving informal investigations and informal criminal references has significant advantages.] As the SEC points out in its *amicus* brief, the procedure permitting preliminary communications with the United States Attorney has significant advantages. Allowing early participation in the case by the United States Attorney minimizes statute of limitations problems. The more time a United States Attorney has, the easier it is for him to become familiar with the complex facts of a securities fraud case, to prepare the case, and to present it to a grand jury before expiration of the applicable statute of limitations. Earlier initiation of criminal proceedings moreover is consistent with a defendant's right to a speedy trial. We decline,

"171.07 *Furnishing Information to Other State and Federal Law Enforcement Agencies.* In cases not falling within Subsections .05 and .06 of this Section, that is, situations other than referral of a matter for State enforcement action, or cooperation with the Post Office Department or other Federal law enforcement officials, *Commission officials are authorized in their discretion to make available to Federal* and State *law enforcement to Federal and State law enforcement* [sic] *agencies information developed in the course of an investigation* other than a formal investigation which has been ordered by the Commission and other non-public information when the Commission official is satisfied that such action clearly will not interfere with the Commission's enforcement functions in the particular case or in other cases." (emphasis added).

as the district court likewise declined, to interfere with this commendable example of inter-agency cooperation.[19]

IV.

This brings us to what we regard as the chief issue in the case—whether the district court in this *criminal* action abused its discretion in dismissing and striking substantial portions of the indictment[20] because of alleged misconduct

[19] Congress only recently has expressed its expectation that this cooperation will continue:

> "Traditionally, there has been a close working relationship between the Justice Department and the SEC. The Committee [on Interstate and Foreign Commerce] fully expects that this cooperation between the two agencies will continue. . . ." H.R. Rep. No. 95-650, 95th Cong., 1st Sess. 10 (Sept. 28, 1977).

[20] Of the twelve count indictment returned by the grand jury on November 8, 1976, the district court's order of June 3, 1977 dismissed eight substantive counts in their entirety, i.e. Counts Four, Five, Six, Seven, Eight, Nine, Ten and Eleven. It also struck from the conspiracy count (Count One) paragraphs 10(d), 10(e), 10(f)(i), 10(f)(ii), 10(f)(iii), 10(f)(iv), 10(f)(v), 10(f)(vi), 10(g)(i), 10(g)(ii), 10(g)(iii), 10(g)(iv), 10(g)(v), 10(h) and 11(e).

This resulted in the dismissal of the indictment in its entirety against three of the five defendants, i.e. Friedman, Davis and Sandberg.

The district court's order left remaining for trial only defendant Fields on paragraphs 10(a), 10(b) and 10(c) of the conspiracy count (Count One), limited to Fields' manipulation of the price of TDA stock; and defendant Berge on Count Twelve for giving false testimony before the SEC. Berge's case was severed for medical reasons.

The theory on which the district court dismissed and struck most of the indictment was that the portions which it dismissed or struck related to "transactions and matters specifically referred to in [the civil consent judgment]." We have some difficulty following the district court's line of demarcation, in dismissing and striking portions of the indictment, even on the district court's own theory. But our difficulty in this respect is of no consequence. We direct that the entire unexpurgated indictment be reinstated.

by employees of the SEC in attempting to settle the *civil* action. On this issue we hold that the district court did abuse its discretion. We reverse and remand with directions to reinstate the unexpurgated indictment.

The district court recognized that, aside from *the most drastic remedy* of dismissing the indictment (as urged by all defendants), there were available at least two alternative remedies, i.e. "admonishment to the SEC" and "[p]ermitting the defendants to reopen the consent judgments entered in the civil suit".[21]

We believe on the facts of this case that the district court, in opting for the most drastic remedy available to it, abused its discretion. The relief granted was wholly out of proportion to the wrong sought to be corrected. And it was contrary to the law of this circuit or any other circuit, so far as we are aware.

The extreme sanction of dismissal of an indictment is justified in order to achieve one or both of two objectives: first, to eliminate prejudice to a defendant in a criminal prosecution;[22] second, to "help to translate the assurances

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[21] Arguments have been addressed to us with respect to these so-called "alternative" remedies, particularly whether the judgment below should be modified accordingly.

We decline the invitation to rule upon anything except what is before us, namely, the order of the district court dismissing and striking substantial portions of the indictment, as to which we reverse.

As for the civil action which was assigned to Judge Pierce—not to Judge Haight—nothing in this opinion is to be construed as expressing or implying any views on our part. That case is not before us.

[22] *United States* v. *Jacobs*, 531 F.2d 87, 90 (2 Cir.) (dismissal of perjury count of indictment affirmed in interest of *prosecutorial* fairness in the same district regarding warning grand jury witness that she was a target of investigation) (emphasis added), *vacated and remanded*, 429 U.S. 909, *aff'd on remand*, 547 F.2d 772 (2 Cir. 1976), *cert. dismissed*, —— U.S. —— (1978), 46 U.S.L.W. 4406 (U.S.

(footnote continued on following page)

of the United States Attorneys into consistent performances by their assistants."[23] Here, dismissal of the indictment served neither objective.

We agree with the district court that the conduct of the SEC employees in concealing their reference of this case to the United States Attorney and in leading defense counsel to believe the opposite was improper. But we fail to see any resulting harm to defendants. By that time defendants, with their backs to the wall because of the New York County District Attorney's anticipated reference of the matter to the SEC, had long since disclosed enough facts to the SEC to enable the government to marshal the evidence and to proceed both civilly and criminally against them. Thus, even assuming arguendo that the SEC was engaged in enforcement of federal *criminal* laws when it negotiated the *civil* consent decree—a proposition about which we have considerable doubt—it clearly was an abuse of discretion for the district court to employ such a severe sanction against the government on the facts of this case.

Even when a *prosecutorial* arm of the government unlawfully obtains evidence, we normally limit the permissible sanction to suppression of the illegally obtained evidence. It is only in the rare case, where it is impossible to restore

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May 1, 1978); *United States* v. *Minnesota Mining & Mfg. Co.*, 551 F.2d 1106, 1112 (8 Cir. 1977) (dismissal of indictment affirmed because of breach of "*prosecutorial* agreement, the inviolability of which rested completely in the province of the government *prosecutors*" (emphasis added)); *United States* v. *Henderson*, 525 F.2d 247, 250 & n. 12 (5 Cir. 1975) (dismissal of indictment affirmed because of failure of *prosecutor* to furnish defendants with transcript of prior state court trial where three of defendants had been acquitted (emphasis added)).

[23] *United States* v. *Estepa*, 471 F.2d 1132, 1137 (2 Cir. 1972) (Friendly, J.); *accord, United States* v. *Jacobs, supra*, 547 F.2d at 778.

a criminal defendant to the position that he would have occupied vis-a-vis the prosecutor, that the indictment may be dismissed. *E.g., United States* v. *Jacobs, supra; United States* v. *Estepa, supra.*

The improper conduct here certainly was not as egregious as that in *United States* v. *Rodman,* 519 F.2d 105 (1 Cir. 1975), where the SEC not only broke its promise but obtained incriminating evidence from the defendant in reliance on that promise. Moreover, the promise there was to "strongly recommend" against prosecution.

As for the deterrence objective of the district court's order here, proper regard for the public interest in the prosecution of crimes counsels restraint in dismissing an indictment for deterrence purposes unless the course of official misconduct is a demonstrated, long-standing one. We have approved this extreme sanction only when the pattern of misconduct is widespread or continuous. *United States* v. *Jacobs, supra; United States* v. *Estepa, supra.*

What we have here is an isolated instance of misconduct by two employees of a large government agency. There is no contention that SEC employees generally fail to disclose to defense counsel the release of relevant information or a criminal reference to the Department of Justice. We know of no other instance where this has occurred.

Since the district court's extreme sanction of dismissal of the indictment is not justified on grounds of eliminating prejudice to the defendants in this criminal prosecution or of deterring widespread or continuous official misconduct, we reverse the order and remand with directions to reinstate the unexpurgated indictment.

Finally, we turn to the district court's alternative grounds [24] for dismissing Counts One, Two, Three and

[24] See note 9 *supra.*

Four. After holding that substantial portions of the indictment must be dismissed or stricken [25] because of the alleged misconduct by SEC employees in attempting to settle the civil action brought by the SEC against those who are defendants in the criminal action, the district court stated that "Quite apart from this basis for decision, there are alternative and compelling legal reasons why certain aspects of the indictment must be dismissed . . . . In order that the case be fully stated for the possible consideration of higher authority, I shall state the reasoning which underlies these alternative conclusions."

The district court then stated its alternative grounds (A) for dismissing Counts One, Two and Three, namely, that, for lack of materiality, the nondisclosure of the ERD kickbacks did not constitute violations of Section 17(a) of the 1933 Act or of the false statements statute, 18 U.S.C. § 1001 (1976); and (B) for dismissing Count Four, namely, that disclosure of the Westcalind and ERD kickbacks in TDA's proxy statements in December 1971 was not required by Section 14(a) of the 1934 Act and the proxy rules promulgated thereunder.

We disagree with the district court's alternative grounds for dismissal of Counts One, Two, Three and Four. We reverse its rulings on this aspect of the case.

(A) *Materiality of Nondisclosure of ERD Kickbacks Under Counts One, Two and Three.*

The district court dismissed Counts One, Two and Three which relate to the ERD kickbacks described in paragraphs 10(f) through 10(h) of Count One. The offense charged in Counts One and Two in substance is that one of the

[25] See note 20, *supra.*

means employed by defendants in their fraudulent scheme was to issue a prospectus for a public offering of TDA common stock in November 1971 which was false and misleading in that it failed to disclose *material facts*—in violation of Section 17(a) of the 1933 Act.[26] Count Three charges defendants with having filed with the SEC a prospectus which concealed *material facts*—in violation of 18 U.S.C. § 1001 (1976).[27]

The theory upon which the district court dismissed these counts, as urged by defendants' counsel, was that as a matter of law the failure to disclose the ERD kickback transactions in the prospectus did not constitute violations

[26] Section 17(a) of the 1933 Act, 15 U.S.C. § 77g(a) (1976), provides:

> "(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

[27] 18 U.S.C. § 1001 (1976) provides:

> "Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be [punished]."

of the statutes because the failure to disclose such transactions was not *material* to an informed decision by a prospective purchaser of TDA stock on the merits of investing in the company.

The error in the district court's ruling in this respect is best pointed up by the Supreme Court's definition of "materiality" and the Court's admonition against deciding that issue as a matter of law in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976):

> "An omitted fact is material if there is a substantial likelihood that a reasonable [investor] would consider it important in deciding [whether to purchase or sell securities] . . . .
>
> Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* at 449.

And, of critical importance here, the Court admonished:

> "The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts. In considering whether summary judgment on the issue is appropriate, we must bear in mind that the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact. *Only if the established omissions are 'so obviously important to an investor, that reasonable minds cannot differ on the question*

of materiality' is the ultimate issue of materiality appropriately resolved 'as a matter of law' by summary judgment.'' Id. at 450. (emphasis added) (citations omitted).

In the instant case, we hold that the government has shown a sufficient basis of materiality as defined by the Supreme Court in *TSC Industries, Inc.* v. *Northway, Inc., supra,* to charge nondisclosure of the ERD kickbacks as a violation of the statutes here involved. Defendants' $300,000 profit on this transaction, while ultimately coming out of the pockets of the defrauded stockholders, may well be immediately recoverable by TDA, Inc. as a short swing purchase and sale under Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1976).

(B) *Disclosure of Westcalind and ERD Kickbacks Under Count Four.*

As its alternative ground for dismissal of Count Four, the district court held that defendants were not required, under Section 14(a) of the 1934 Act [28] and Rule 14a-9 [29]

[28] Section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1976), provides:

> "It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title."

[29] Rule 14a-9 promulgated under the Exchange Act, 17 C.F.R. § 240.14a-9 (1977), in relevant part provides:

(footnote continued on following page)

promulgated thereunder, to disclose the Westcalind and ERD kickbacks in proxy statements distributed in December 1971. We disagree.

Item 7(f) of Schedule 14A, 17 C.F.R. § 240.14a-101(f) (1977), requires disclosure of:

> "any transactions since the beginning of the issuer's last fiscal year . . . to which the issuer *or any of its subsidiaries* was or is to be a party, in which any of the following persons had or is to have a direct or indirect material interest . . . (1) Any director or officer of the issuer; (2) Any nominee for election as a director . . . ." (emphasis added).

If proven, defendants' failure to disclose their interest in the Westcalind kickbacks certainly would be a violation of Item 7(f) and consequently of Section 14(a).

Item 7(e)(4) of Schedule 14A, 17 C.F.R. § 240.14a-101 (1977), requires disclosure of:

> "indebted[ness] to the issuer . . . [of e]ach director or officer of the issuer . . . [including] any indebtedness . . . [which] arose under Section 16(b) of the [Securities Exchange] Act. . . ."

Defendants' sale of TDA shareholders' lettered stock immediately after acquiring it in a private placement—the ERD kickbacks—clearly would violate Section 16(b). Ac-

> "(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."

cordingly, their failure to disclose these kickbacks, if proven, would constitute a violation of Item 7(e)(4) and consequently of Section 14(a).

To summarize:

(1) We affirm the district court's holding that the informal criminal reference of this case by the SEC to the United States Attorney was not contrary to the applicable statutes, rules and regulations.

(2) We reverse the district court's dismissal and striking of substantial portions of the indictment because of alleged misconduct by SEC employees in attempting to settle a civil action.

(3) We reverse the district court's dismissal of Counts One, Two, Three and Four on alternative grounds.

(4) We remand the case with directions to reinstate the unexpurgated indictment and to proceed with the case in the district court according to law.

Affirmed in part; reversed and remanded in part.

MANSFIELD, *Circuit Judge* (Concurring):

I concur in Judge Timbers' carefully considered opinion. I would only add that in my view the conduct of the SEC representatives (Tucker and Perlmutter) in continuing to negotiate a civil settlement after appellants' counsel had repeatedly stated that they were negotiating on the basis that there would not be any criminal reference was deceitful and duplicitous.

Judge Haight found that at the very first meeting between defense counsel and Messrs. Tucker and Perlmutter, which took place on January 14, 1975, Tucker was advised that defense counsel's objective was "the avoidance of a

criminal reference" and this was made clear to the same SEC counsel at a meeting on February 28, 1975. Moreover, after rejecting Tucker's testimony to the effect that he had in September 1975 told defense counsel that there was "no deal on criminal" Judge Haight further found that on September 30, 1975, former Judge Streit, who was substituting for Mr. Gould as chief defense counsel, advised that "in light of the fact that there [was] to be no criminal prosecution," he would endeavor to obtain the amount of the repayment demanded by the SEC, to which Tucker and Perlmutter made no response even though Perlmutter had in the interim been in communication with the U.S. Attorney about the case. In October 1975 Perlmutter confirmed to a lawyer representing a prospective outside director of TDA that there would be no criminal reference, and an attorney for appellant Sandberg told Tucker and Perlmutter that he would advise his client to settle, since settlement was "better than going over to the golden dome [U.S. Courthouse]," to which the SEC counsel made no response.

Once they were advised by appellants' counsel of the basis on which the latter were proceeding, SEC counsel surely owed an ethical obligation immediately to correct the record by advising counsel that they had already initiated an informal criminal reference or at least that they felt free to do so. However, since appellants' counsel, with no viable alternative, faced the prospect that the incriminating evidence would in any event be forwarded by the New York County District Attorney to the SEC without restrictions on its use no prejudice warranting dismissal of the indictment is shown.

APPENDIX D

UNITED STATES COURT OF APPEALS

FOR THE

SECOND CIRCUIT

77-1342

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the fourteenth day of September one thousand nine hundred and seventy-eight

Present:

HON. WILFRED FEINBERG
HON. WALTER R. MANSFIELD
HON. WILLIAM H. TIMBERS

Circuit Judges,

UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG, and ERIC BERGE,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed in part, reversed in part and remanded in part in accordance with the opinion of this court.

A. DANIEL FUSARO,
Clerk

By: /s/ ARTHUR HELLER
Deputy Clerk

APPENDIX E

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

DOCKET No. 77-1342

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the fourteenth day of February, one thousand nine hundred and seventy-nine.

Present:

HON. WILFRED FEINBERG
HON. WALTER R. MANSFIELD
HON. WILLIAM H. TIMBERS

Circuit Judges.

UNITED STATES OF AMERICA,

Appellant,

v.

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG, and ERIC BERGE,

Defendants-Appellees.

ORDER ON PETITIONS FOR REHEARING

Petitions for rehearing having been filed herein by counsel for defendants-appellees, pursuant to F.R.A.P. 40, addressed to this Court's panel opinions of September 14, 1978, F.2d , slip op. 4717; and

The Court, by an order entered January 3, 1979, having granted the motion of the Securities and Exchange Commission for leave to file a memorandum amicus curiae with respect to the pending petitions for rehearing; and

The Court having received letters from counsel for various parties, including counsel for appellant the United States and counsel for appellee Fields, with respect to the claims raised in the said petitions and memorandum; and having received a response from counsel for appellee Friedman to the amicus curiae memorandum of the Securities and Exchange Commission; and

The Court having given due consideration to all claims raised in the petitions for rehearing, the memorandum and papers referred to above; and

The Court having concluded that certain technical corrections should be made in the Court's panel opinion, slip op. 4726-4731; and that such corrections, while not affecting the result of our decision in any way, should be made in the public interest to avoid confusion with respect to the SEC's investigatory and criminal reference procedures; it is therefore

ORDERED that the following corrections hereby are made in our opinion of September 14, 1978:

(1) *Slip op. 4726, lines 10-13.*

Change "Tucker had made an informal criminal reference of the TDA matter to the United States Attorney's office on December 1, as stated below." to read:

"Tucker had communicated with the United States Attorney's office concerning the TDA matter on December 1, as stated below."

(2) *Slip op. 4726, lines 26-28.*

Change "made an informal criminal reference of the TDA matter to Assistant United States Attorney Wing" to read:

"communicated regarding the TDA matter with Assistant United States Attorney Wing".

(3) *Slip op. 4727, lines 7-9.*

Change "the informal criminal reference of this case by the SEC to the United States Attorney's office" to read:

"the communications regarding this case by the Commission's staff to the United States Attorney's office".

(4) *Slip op. 4727-4728, last full paragraph beginning on 4727 and carrying over to 4728.*

Delete, "It is important . . . criminal reference.[11]" and insert in lieu thereof:

"It is important to bear in mind the distinctions, under SEC procedure, between preliminary communications between the Commission's staff and the United States Attorney's office, which may occur in the context of either a formal or informal investigation, and Commission criminal references, which may in turn be either formal or informal.[11]"

(5) *Slip op. 4728, lines 4-5.*

Delete, "which was utilized in the instant case".

(6) *Slip op. 4728, line 9.*

Delete, ("not utilized here)".

(7) *Slip op. 4731, lines 5-7.*

Delete, "at an early stage of an investigation, that is, during an informal or preliminary investigation" and insert in lieu thereof:

"at an early stage of either a formal or informal investigation."

(8) *Slip op. 4731, lines 7-12.*

Delete the three sentences, "In the instant case . . . regulations."

(9) *Slip op. 4731, lines 14-16.*

Delete the sentence, "As the SEC . . . advantages." and insert in lieu thereof:

"As the SEC points out in its *amicus* brief, the procedure permitting preliminary communications with the United States Attorney has significant advantages."

and it is further

ORDERED that in all other respects the petitions for rehearing are denied and the panel opinions are adhered to.

/s/ WILFRED FEINBERG
WILFRED FEINBERG

/s/ WALTER R. MANSFIELD
WALTER R. MANSFIELD

/s/ WILLIAM H. TIMBERS
WILLIAM H. TIMBERS
Circuit Judges

Appendix E

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

77-1342

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the fourteenth day of February, one thousand nine hundred and seventy-nine.

UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG, ERIC BERGE,

Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the defendant-appellee, Peter S. Davis, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said suggestion for rehearing en banc be and it hereby is DENIED.

/s/ IRVING R. KAUFMAN
IRVING R. KAUFMAN
Chief Judge

Appendix E

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

77-1342

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the fourteenth day of February, one thousand nine hundred and seventy-nine.

UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG, ERIC BERGE,

Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the defendants-appellees, Frederick M. Friedman and Eric Berge, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said suggestion for rehearing en banc be and it hereby is DENIED.

/s/ IRVING R. KAUFMAN
IRVING R. KAUFMAN
Chief Judge

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77-1342

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UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG, ERIC BERGE,

Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for defendants-appellees, Douglas P. Fields, & Alan E. Sandberg, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said suggestion for rehearing en banc be and it hereby is DENIED.

/s/ IRVING R. KAUFMAN
IRVING R. KAUFMAN
Chief Judge

Appendix E

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

77-1342

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the fourteenth day of February, one thousand nine hundred and seventy-nine.

Present:

HON. WILFRED FEINBERG
HON. WALTER R. MANSFIELD
HON. WILLIAM H. TIMBERS
Circuit Judges.

UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG, ERIC BERGE,

Defendants-Appellees.

A petition for a rehearing having been filed herein by counsel for the defendants-appellees, Douglas P. Fields and Alan E. Sandberg,

Upon consideration thereof, it is

Ordered that said petition be and hereby is DENIED.

A. DANIEL FUSARO
Clerk

Appendix E

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

77-1342

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the fourteenth day of February, one thousand nine hundred and seventy-nine.

Present:

HON. WILFRED FEINBERG
HON. WALTER R. MANSFIELD
HON. WILLIAM H. TIMBERS
Circuit Judges.

UNITED STATES OF AMERICA,
Plaintiff-Appellant,

v.

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG, ERIC BERGE,
Defendants-Appellees.

A petition for a rehearing having been filed herein by counsel for the defendants-appellees, Frederick M. Friedman and Eric Berge,

Upon consideration thereof, it is

Ordered that said petition be and hereby is DENIED.

A. DANIEL FUSARO
Clerk

Appendix E

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

77-1342

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the fourteenth day of February, one thousand nine hundred and seventy-nine.

Present:

HON. WILFRED FEINBERG
HON. WALTER R. MANSFIELD
HON. WILLIAM H. TIMBERS
Circuit Judges.

UNITED STATES OF AMERICA,
Plaintiff-Appellant,

v.

DOUGLAS P. FIELDS, FREDERICK M. FRIEDMAN, PETER S. DAVIS, ALAN E. SANDBERG, ERIC BERGE,
Defendants-Appellees.

A petition for a rehearing having been filed herein by counsel for the defendant-appellee, Peter S. Davis,

Upon consideration thereof, it is

Ordered that said petition be and hereby is DENIED.

A. DANIEL FUSARO
Clerk

Nos. 78-1474, 78-1480 and 78-1483

Supreme Court, U.S.
FILED
MAY 18 1979
... RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1978

DOUGLAS P. FIELDS AND ALAN E. SANDBERG, PETITIONERS

v.

UNITED STATES OF AMERICA

PETER S. DAVIS, PETITIONER

v.

UNITED STATES OF AMERICA

FREDERICK M. FRIEDMAN, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General

PHILIP B. HEYMANN
Assistant Attorney General

JOSEPH S. DAVIES, JR.
WADE LIVINGSTON
Attorneys
Department of Justice
Washington, D.C. 20530

INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statement	2
Argument	7
Conclusion	15

CITATIONS

Cases:

Brotherhood of Locomotive Firemen & Enginemen v. *Bangor & Aroostook Railroad Co.,* 389 U.S. 327	8
Cogen v. *United States,* 278 U.S. 221	7
Cooke v. *Teleprompter Corp.,* 334 F. Supp. 467	9
Costello v. *United States,* 350 U.S. 359	14
Foremost McKesson, Inc. v. *Provident Securities Co.,* 423 U.S. 232	10
Hampton v. *United States,* 425 U.S. 484	15
SEC v. *Jos. Schlitz Brewing Co.,* 452 F. Supp. 824	9
SEC v. *Kalvex Inc.,* 425 F. Supp. 310	9
TSC Industries, Inc. v. *Northway, Inc.,* 426 U.S. 438	8
United States v. *Caceres,* No. 76-1309 (Apr. 2, 1979)	12

Page

Cases—Continued:

United States v. *Calandra*, 414 U.S. 338 14

United States v. *MacDonald*, 435 U.S. 850 7

United States v. *Parrott*, 425 F. 2d 972, cert. denied, 400 U.S. 824 13

United States v. *Rodman*, 519 F. 2d 1058 13

Statutes and regulations:

Securities Act of 1933, 15 U.S.C. 77 *et seq.*:

Section 17(a), 15 U.S.C. 77q(a) 3

Section 20(b), 15 U.S.C. 77t(b) 12

Securities Exchange Act of 1934, 15 U.S.C. 78 *et seq.*:

Section 14(a), 15 U.S.C. 78n(a) 3, 10, 11

Section 16(b), 15 U.S.C. 78p(b) 10, 11

Section 21(e), 15 U.S.C. 78u(e) 12

Section 32, 15 U.S.C. 78ff 11

18 U.S.C. 371 2

18 U.S.C. 1001 3

18 U.S.C. 1341 3

18 U.S.C. 1343 3

17 C.F.R. 240.14a-9 10

17 C.F.R. 240.14a-101(e)(4) 11

17C.F.R. 240.14a-101(f) 11

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-1474

DOUGLAS P. FIELDS AND ALAN E. SANDBERG, PETITIONERS

v.

UNITED STATES OF AMERICA

No. 78-1480

PETER S. DAVIS, PETITIONER

v.

UNITED STATES OF AMERICA

No. 78-1483

FREDERICK M. FRIEDMAN, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 79a-105a) is reported at 592 F. 2d 638. The opinions of

the district court (Pet. App. 1a-74a, 75a-78a) are not reported.

JURISDICTION

The judgment of the court of appeals (Pet. App. 106a-107a) was entered on September 14, 1978. A petition for rehearing was denied on February 14, 1979. On March 8, 1979, Mr. Justice Marshall extended the time within which to file a petition for a writ of certiorari to and including March 26, 1979. The petitions in Nos. 78-1474 and 78-1480 were filed on March 26, 1979. The petition in No. 78-1483 was filed on March 27, 1979, and is therefore one day out of time. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether an indictment charging that petitioners received substantial undisclosed kickbacks while serving as officers and directors of two publicly-held corporations adequately alleges that they failed to disclose material facts in violation of the federal securities laws.

2. Whether the indictment should have been dismissed because the Securities and Exchange Commission failed to reveal, at the time that it consummated a settlement of a civil proceeding brought against petitioners, that it had recommended an investigation and criminal prosecution of petitioners.

STATEMENT

1. In November 1976, a grand jury of the United States District Court for the Southern District of New York returned a 12-count indictment against petitioners and one co-defendant, alleging conspiracy to violate the securities laws, in violation of 18 U.S.C. 371, fraud

in the sale of securities, in violation of 15 U.S.C. 77q(a), fraud in the solicitation of proxies, in violation of 15 U.S.C. 78n(a), fraud in filing a registration statement and prospectus with the Securities and Exchange Commission, in violation of 18 U.S.C. 1001, and mail and wire fraud, in violation of 18 U.S.C. 1341 and 1343 (Pet. App. 81a-82a).

The fraudulent transactions alleged in the complaint involved two publicly traded corporations, TDA Industries, Inc. (TDA), and its subsidiary, Westcalind Corp. (Westcalind). Petitioners served as officers and directors of the two corporations.[1] The basis for the charges in the indictment were the following transactions, occurring between March 1971 and March 1973:

(a) In March 1971, petitioners Fields and Friedman caused Westcalind to pay $50,000 to a third party for services that were not performed. Of that sum, $35,000 was repaid to petitioners Fields and Friedman for their personal use (Pet. App. 4a-5a). These transactions were referred to as the "Westcalind kickback" in the lower courts (Pet. App. 4a-5a).

(b) In April and May 1971, petitioners Fields, Friedman and Davis purchased (through a nominee) several thousand shares of unregistered TDA stock from an investment company (ERD) and from certain other investors at a price substantially below market price. They falsely represented to the sellers that the

---

[1]Petitioner Fields served as president and chairman of the board of directors of TDA and Westcalind. Petitioner Friedman served as vice-president, secretary and treasurer of TDA, as well as treasurer and director of Westcalind. Petitioner Sandberg served as vice-president and director of TDA, as well as director of Westcalind. Petitioner Davis was TDA's attorney and also served as a Westcalind director (Pet. App. 8a).

stock could only be disposed of at a discount in a private placement transaction. By prearrangement, however, those shares were immediately registered by petitioners and resold to the public at a substantial profit, 70% of which was recovered by petitioners. This transaction was referred to as the "ERD kickback" in the lower courts (Pet. App. 5a).

(c) In November 1971, petitioner Fields paid various persons to purchase substantial quantities of TDA stock on the open market prior to a public offering of TDA stock. The purpose of those purchases was to cause the market price of TDA stock to rise to an artificially high and inflated level (Pet. App. 4a).

(d) In February and March 1973, petitioners Friedman and Sandberg caused TDA to pay a third party $100,000 for services that were not performed. The third party then refunded $82,000 to petitioners Friedman and Sandberg. This was described as the "Eagle Roofing kickback" in the lower courts (Pet. App. 6a).

Based on these transactions, counts 1 and 2 of the indictment charged that petitioners Fields, Friedman and Davis conspired to, and did in fact, commit fraud in the November 1971 sale of TDA stock. That fraud resulted from their market manipulation activities and from their failure to disclose the ERD and Westcalind kickbacks in offering prospectuses disseminated to public investors. Counts 3, 4 and 5 charged that petitioners Fields, Friedman and Davis filed a false registration statement with the SEC regarding the TDA stock offering. Those counts also charged that petitioners Fields, Friedman and Davis distributed false proxy solicitations to TDA stockholders in December 1971 that failed to disclose the market manipulation

scheme and the ERD and Westcalind kickbacks. Counts 6 through 11 of the indictment charged petitioners Friedman and Sandberg with wire and mail fraud violations that occurred during the course of the Eagle Roofing kickback (Pet. App. 81a-83a).

2. Petitioners moved to dismiss the indictment based upon alleged governmental misconduct. In response, the district court conducted a hearing and made findings of fact regarding the events preceding the return of the indictment. The evidence showed that in 1974 the District Attorney of New York County commenced an investigation of petitioners' activities. In January 1975, he concluded that petitioners' conduct was not properly the subject of state law enforcement but rather was a matter for investigation by federal authorities. Recognizing that the District Attorney was planning to refer the case to the Securities and Exchange Commission, petitioners decided to disclose some of their illegal activities to the SEC in the hope that they could negotiate a favorable settlement and avert a federal criminal prosecution (Pet. App. 9a).

In September 1975, the SEC filed a civil complaint against petitioners seeking, *inter alia,* disgorgement of funds fraudulently obtained from TDA stockholders, the appointment of a receiver, and an injunction to bar petitioners Fields and Friedman from serving as officers or directors of TDA (Pet. App. 16a, 22a-23a). Both before and after the filing of the civil complaint, petitioners' attorneys met with the SEC attorneys and stated their assumption that the SEC would not recommend a criminal prosecution. The SEC attorneys did not correct this misimpression. In addition, the district court found that an SEC attorney stated to a third party that there would be no criminal reference

after the civil suit was settled. That statement was later repeated by the third party to petitioner Fields (Pet. App. 18a-19a).

On December 1, 1975, the SEC attorneys sent pleadings that had been publicly filed in the SEC's civil proceeding to the United States Attorney (Pet. App. 20a). They did not disclose that fact during continued negotiations with petitioners. Shortly thereafter, petitioners agreed to settle the civil action by submitting to an injunction and other ancillary relief (*id.* at 21a-24a). The United States Attorney subsequently investigated the TDA case, presented the matter to a grand jury, and obtained an indictment on November 8, 1976 (*id.* at 89a).

3. Based on an exercise of its "supervisory powers," the district court dismissed substantial portions of the indictment. Although the court rejected the contention that the SEC had expressly promised petitioners not to refer their case to the United States Attorney (Pet. App. 27a-28a), it nonetheless concluded that the SEC attorneys, in light of all the circumstances, had misrepresented their intention with respect to a criminal referral (*id.* at 36a).[2] As an alternative ground for decision, the district court held that substantial portions of counts 1, 2 and 3 of the indictment were

[2]The government did not challenge on appeal the factual findings of the district court. Accordingly, we do not address here whether the district court was correct in crediting the testimony of petitioners' counsel who, as the court of appeals noted, were well "aware of the SEC's long standing and well known policy *against* settling civil actions in a manner that would impair subsequent criminal prosecutions." Pet. App. 86a-87a (emphasis in original). The court of appeals also noted that many of the district court's findings "hinged on close questions of credibility." Pet. App. 85a n.5.

deficient because the ERD kickback was not, as a matter of law, "material" to investors who purchased TDA stock in November 1971. Similarly, the court held that count 4 of the indictment was deficient because the ERD and Westcalind kickbacks were not, as a matter of law, "material" to TDA stockholders who received proxy solicitations in December 1971 (Pet. App. 46a-57a, 74a).

The court of appeals reversed, holding that the district court abused its discretion in dismissing the indictment. Although it too was critical of the SEC attorneys, the court of appeals held that under all the circumstances the extreme sanction of dismissal was not necessary to avoid "prejudice to the defendants in this criminal prosecution" or to deter widespread official misconduct (Pet. App. 98a). The court also noted that the "materiality" of the self-dealing transactions concealed by petitioners presented a mixed question of law and fact, rather than a pure question of law susceptible to disposition on a motion to dismiss (*id.* at 99a-104a).

ARGUMENT

1. Even if petitioners' claims would otherwise merit review, this Court should not now consider their challenges to the court of appeals' reinstatement of the indictment. The ruling below places petitioners in precisely the same procedural position they would have occupied if the district court had denied their motions to dismiss. Such an interlocutory order would not have been subject to pretrial appeal. See *United States* v. *MacDonald,* 435 U.S. 850, 853-863 (1978); *Cogen* v. *United States,* 278 U.S. 221, 222, 224 (1929). The same considerations that counsel against interlocutory appeals of denials of motions to dismiss weigh against

interlocutory review by this Court of the issues now presented by petitioners. Petitioners were indicted over two years ago and have not yet been tried. At trial, petitioners may be acquitted, in which event their claims will be moot. If, on the other hand, petitioners are convicted and their convictions are affirmed, they will be able to present all of their contentions to this Court when seeking review of the final judgment. See generally *Brotherhood of Locomotive Firemen & Enginemen* v. *Bangor & Aroostook Railroad Co.*, 389 U.S. 327, 328 (1967).

2. In any event, the decision of the court of appeals is correct and does not warrant further review.

Petitioners contend (Fields Pet. 13-18; Friedman Pet. 31-36) that the court of appeals erred in reinstating counts 1-4 of the indictment because those counts merely allege concealment of immaterial information. However, the indictment expressly charges that the undisclosed information was "material" (Pet. App. 100a). And as this Court held in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 450 (1976), determinations of "materiality" require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact." The Court's admonitions in *Northway* against resolving disputed issues of materiality on motions for summary judgment apply with even greater force to motions to dismiss.

a. Counts 1-3 of the indictment charge that petitioners failed to disclose various material facts in the offering prospectus disseminated to public investors in November 1971. Among the material facts alleged to have been concealed were the ERD kickbacks of April

and May 1971. The government is prepared to present evidence showing that these kickbacks defrauded TDA shareholders of $435,000 and served to personally enrich the company's President, Vice-President, and corporate counsel. Nothing could have been more material to potential TDA investors than to know that, only five months earlier, other investors in TDA had been cheated out of $435,000 by the company's two highest officers and attorney. A reasonable investor surely would have found that disclosure of this self-dealing scheme "significantly altered the 'total mix' of information made available." *TSC Industries, Inc.* v. *Northway, Inc., supra,* 426 U.S. at 449.[3] Moreover, potential investors certainly would have wanted to consider the future adverse consequences to the corporation of petitioners' misdeeds. As the SEC's civil complaint demonstrated, intentional securities fraud by management may result in corporate receivership. Private litigation brought against the company as a result of such fraud may also result in substantial expense and exposure to large civil liabilities. In sum, the government was entitled to present evidence to the jury to prove that the ERD kickback scheme was a material fact requiring disclosure to the investing public.

[3]Improper activities bearing on the integrity of a company's management have been held to be material under the *Northway* test. See, *e.g.*, *SEC* v. *Jos. Schlitz Brewing Co.*, 452 F. Supp. 824, 829-830 (E.D. Wis. 1978). Cf. *SEC* v. *Kalvex Inc.*, 425 F. Supp. 310, 315 (S.D. N.Y. 1975); *Cooke* v. *Teleprompter Corp.*, 334 F. Supp. 467 (S.D. N.Y. 1971). Besides showing the corruption of the management of the company soliciting additional funds, this information would show potential investors that management was deeply indebted to the company for "short swing" profits (see Pet. App. 102a). The ERD kickback scheme involved purchases and sales of large quantities of stock by

b. Count 4 of the indictment charges that petitioners Fields, Friedman and Davis violated Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a), and Rule 14a-9 thereunder, 17 C.F.R. 240.14a-9, as a result of their dissemination to TDA stockholders of misleading proxy solicitations in December 1971. The matter for which proxies were solicited was the election of corporate directors, including petitioner Friedman. Count 4 charges that the proxy solicitations omitted to state material facts pertaining to the qualifications of petitioner Friedman for the position of corporate director, including his participation along with the other defendants in the March 1971 Westcalind kickback and the April and May 1971 ERD kickback.

Petitioner Friedman's involvement in fraudulent self-dealing transactions that had the effect of cheating TDA stockholders and of depleting the assets of a TDA subsidiary (Westcalind) was directly relevant to his qualification to serve as a director. Contrary to petitioners' contentions (Friedman Pet. 36-40), it certainly cannot be said that, as a matter of law, a reasonable shareholder would have viewed as insignificant the fact that petitioner Friedman and his co-defendants had cheated TDA stockholders (the ERD group) of $435,000 and caused one of the company's subsidiaries to pay an improper $50,000 "finder's fee" in order to personally enrich themselves (Pet. App. 4a-6a, 82a-83a). Indeed, it is unlikely that

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statutory insiders within a few days of each other. Under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), petitioners could be required to disgorge the profits made on these transactions. See generally *Foremost McKesson, Inc.* v. *Provident Securities Co.*, 423 U.S. 232, 243-244, 251 (1976).

any reasonable shareholder would have voted for petitioner Friedman if this information had been disclosed. Such information, bearing directly on the honesty of the director to be elected, is of fundamental relevance to the election process.

Moreover, Item 7(f) of Schedule 14A, 17 C.F.R. 240.14a-101(f), specifically required petitioners to disclose "any transactions * * * to which the issuer or any of its subsidiaries was * * * a party, in which any of the following persons had or is to have a direct or indirect material interest. * * * (1) Any director or officer of the issuer; (2) Any nominee for election as a director * * *." Petitioners' involvement in the Westcalind kickback transaction plainly had to be disclosed under this standard (see Pet. App. 103a). Finally, Item 7(e)(4) of Schedule 14A, 17 C.F.R. 240.14a-101(e)(4), expressly requires the proxy solicitation to disclose the "indebted[ness] to the issuer * * * [of each] director or officer of the issuer * * * [including] any indebtedness * * * [that] arose under Section 16(b) of the Act * * *." Because petitioners' sale of TDA stock immediately after acquiring it during the ERD kickback scheme (see note 5, *supra*) would give rise to liability under Section 16(b) of the Securities Exchange Act (Pet. App. 103a), petitioners' failure to disclose the liability violated the proxy rules.[4]

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[4]In a criminal prosecution such as this, the government is only required to prove a willful violation under Section 14(a) and the SEC rules promulgated thereunder. See Section 32 of the Act, 15 U.S.C. 78ff. Questions of "causation," while relevant in civil damage actions, are not relevant in a criminal proceeding. Civil cases of the kind relied on by petitioners (Friedman Pet. 36-38), which have considered the question whether securities law violations caused compensable injury to the plaintiff, are not pertinent here.

2. Petitioners contend (Fields Pet. 19-22; Friedman Pet. 21-30) that the indictment should have been dismissed because SEC employees did not follow required procedures when recommending investigatory action by the United States Attorney.

Both courts below correctly rejected this claim (Pet. App. 32a-33a, 90a-95a). As the lower courts noted, the relevant statutes (15 U.S.C. 77t(b) and 78u(e)) simply provide that the SEC may transmit evidence of securities law violations to the Attorney General, who, in his discretion, may seek an indictment. The statutes do not suggest that it is improper for members of the Commission's staff to communicate formally or informally with the United States Attorney, and the Commission's regulations encourage such cooperation (see Pet. App. 92a-94a). Moreover, even if the SEC failed to follow its normal procedures in transmitting information to the United States Attorney, that alone would not require suppression of the information or dismissal of the indictment. See generally *United States* v. *Caceres*, No. 76-1309 (Apr. 2, 1979).

In any event, the United States Attorney's authority and duty to prosecute violations of the law are not dependent upon a delegation by the SEC. The Attorney General, acting through the United States Attorney, is empowered to enforce all federal criminal statutes, including the securities laws. The statutory provisions relied on by petitioners clearly state that the decision to prosecute is a matter of discretion vested in the federal executive, not the SEC. Hence, an improper reference would not affect the validity of the indictment.

3. Finally, petitioners contend (Fields Pet. 22-25; Friedman Pet. 7-21) that the indictment should have been dismissed because SEC attorneys failed to disclose that they had urged the United States Attorney to conduct a criminal investigation before concluding a settlement with petitioners in the civil injunctive proceeding. We agree with the district court and the court of appeals that this conduct by certain members of the Commission's staff was improper.[5] But, as the court of appeals pointed out (Pet. App. 97a-98a), petitioners suffered no prejudice whatsoever in the criminal action as a result of the SEC's behavior, and therefore "[t]he relief granted [by the district court] was wholly out of proportion to the wrong sought to be corrected" (*id.* at 96a). Throughout the civil investigation, petitioners relied on their privilege against self-incrimination, and the government gained no incriminating evidence from them that could be used at trial. See *United States* v. *Parrott*, 425 F. 2d 972, 976 (2d Cir.), cert. denied, 400 U.S. 824 (1970). Because petitioners received no unfulfilled promises and made no self-incriminating statements, this case is quite different from *United States* v. *Rodman*, 519 F. 2d 1058, 1059 (1st Cir. 1975), where "the Securities and Exchange Commission had obtained substantial information, including self-incriminating statements from the appellee on the basis of a promise * * * [that] was never fulfilled."[6]

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[5]Both of the SEC lawyers directly involved in the negotiations with petitioners' counsel have since resigned their positions with the government.

[6]There is thus no conflict between the decision of the court of appeals in this case and the decision in *Rodman*. We also note that the court of appeals did not hold, as petitioners contend, that the district court's supervisory jurisdiction could never empower it to dismiss an indictment; rather, the court held that, under the facts of this case, such an extreme sanction was unwarranted and an abuse of discretion (see Pet. App. 98a).

There is no suggestion in the record that petitioners ever received a promise of immunity from prosecution. Rather, the district court's theory was that the SEC attorneys were bound, as a matter of fairness, to disclose their communication with the United States Attorney and their intention to make a criminal reference, so that petitioners would not be misled into settling the civil action on the basis of a misunderstanding. Even on that assumption, however, the misconduct involved here could only have affected the civil settlement, because it may have led petitioners to enter into the settlement in ignorance of an event relevant to their expected *quid pro quo.*[7] There was nothing objectionable about the criminal prosecution itself: as noted above, no promise had been given that the case would not be prosecuted, and the United States Attorney had an independent duty to enforce the statute.[8] Thus, regardless of the sources of the prosecutor's information and the conduct of the persons who transmitted it, the valid indictment, returned by a legally constituted grand jury, "is enough to call for trial of the charge on the merits." *Costello* v. *United States,* 350 U.S. 359, 363 (1956). See *United States* v. *Calandra,* 414 U.S. 338, 349-352 (1974). The court of appeals properly concluded that the district court's "supervisory" authority did not, in the circumstances presented here, empower it to

[7]The court of appeals did not foreclose the possibility that the civil settlement might be modified, if appropriate, to remedy any actual prejudice resulting from the SEC misconduct (Pet. App. 96a n.21).

[8]The district court specifically noted: "I find no fault with the actions of any member of the office of the United States Attorney for this district" (Pet. App. 45a).

exercise "a 'chancellor's foot' veto over law enforcement practices of which it did not approve." *Hampton* v. *United States,* 425 U.S. 484, 490 (1976).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WADE H. MCCREE, JR.
Solicitor General

PHILIP B. HEYMANN
Assistant Attorney General

JOSEPH S. DAVIES, JR.
WADE LIVINGSTON
Attorneys

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 74-1474

DOUGLAS P. FIELDS and ALAN E. SANDBERG,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONERS' REPLY BRIEF

SIMON H. RIFKIND
345 Park Avenue
New York, New York 10022
(212) 644-8000
Attorney for Petitioner Douglas P. Fields

Of Counsel:

MAX GITTER
MAX FRIEDMAN
PAUL, WEISS, RIFKIND
WHARTON & GARRISON

NORMAN S. OSTROW
375 Park Avenue
New York, New York 10022
(212) 832-3611
Attorney for Petitioner Alan E. Sandberg

Of Counsel:

FRANK WRIGHT
GRAND & OSTROW

Adams Press Corp., 130 Cedar Street, N. Y. 10006—(212) 233-1050

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PETITIONERS' REPLY BRIEF

The government's typical, back-of-the-hand style of opposition brief cannot diminish the importance of the legal issues raised by this petition. As to the facts: the government, like the Court of Appeals majority, has bowdlerized the shocking findings of the district court and has otherwise mistreated of the record.*

* This is, of course, not the place for a lengthy counterstatement of facts. We therefore respectfully urge the Court to compare Judge Haight's painstaking, and undisturbed, findings with the highly expurgated, and inaccurate, version of the facts in the government's submission.

I

In an effort to narrow the Second Circuit's sweeping decision, the government (Br. p. 9) characterizes it as holding that "improper activity" by a corporate officer is "material" because it bears upon the "integrity of management." That characterization only highlights the need for review by this Court, and at this time.

The rubric, "integrity of management," is an utterly limitless test of "materiality" that has been the SEC's standard for wreaking enormous susbtantive changes in the securities laws. Under that banner, a body of statutes designed as a set of disclosure requirements has been transformed, for example, into an ethical code for corporate executives, prohibiting (before any Congressional legislation on the subject) foreign "questionable" payments, "perks," and other conduct deemed objectionable by the SEC or its staff.*

This new, evolving federal code of corporate ethics may well be salutory. But the legal community, and now an SEC Commissioner as well, have become increasingly disturbed because (a) this code is being "enacted" by SEC expansion of the securities laws far beyond their jurisdictional frontiers as established by Congress; and (b) this expansion of law has been, and is being, effected without

* *See generally* R. Karmel, "Management Fraud—What are the Standards?" (Address, Annual Cooperative Securities Regulation Seminar) (October 27, 1978).

judicial review—largely through consent decrees entered into by the SEC with hundreds of public corporations.*

We submit that this important issue—whether, and when, the notion of "integrity of management" can render corporate or personal conduct "material"—warrants consideration by this Court now, before an all-embracing view of SEC disclosure becomes entrenched national law through continued default or acquiescence. This case, moreover, in its present procedural posture, is an especially appropriate vehicle for consideration of the issue: the contrasting opinions of the courts below put the issue in sharp relief. The district court, in finding no materiality, focused on the absence of injury to—or even effect upon—the corporation (A 48-49, 52-53); the circuit court, in finding materiality, focused instead on the possibility that defendants "may well" have engaged in improper or unlawful conduct (A 100-104).

In these circumstances, the government's arguments (Br. pp. 7-8) concerning the procedural status of the case ring hollow. This Court—in this very term—has not hesitated to grant *certiorari* where, as here, a case posed a significant legal question, even though the appeal was in some sense "interlocutory." For example, in *Broadcast Music, Inc.* v. *CBS, Inc.*, 47 U.S.L.W. 4359 (April 17, 1979), the Court reviewed a determination of the Court of Appeals, after that panel, on a certification, had reinstated the complaint and remanded the cause to the dis-

* *See e.g.*, R. Karmel, *supra;* Report of the Advisory Committee on Corporate Disclosure to the Securities & Exchange Commission, House Comm. on Interstate and Foreign Commerce, 318-19 (Nov. 3, 1977); Kripke, *Where Are We on Securities Disclosure After the Advisory Committee Report,* 6 *Sec. Reg. L. J.* 99 (1978); Klein, *A Response on SEC Consents—'Process is Corrupting All'*, Legal Times of Wash., June 26, 1978, at 21; Werner, *Management, Stock Market and Corporate Reform*: *Berle and Means Reconsidered,* 77 *Col. L. Rev.* 388 (1977).

trict court for further proceedings. And in *Herbert* v. *Lando,* 47 U.S.L.W. 4401 (April 18, 1979), this Court reviewed a decision of the Court of Appeals on an issue that was brought to the Court of Appeals by certification—in the midst of pre-trial discovery. Denial of *certiorari* in *Herbert*—just as the government says of this case (Br. p. 8)—might well have resulted in a "mooting" of the issue, had plaintiff subsequently prevailed at trial.

And the possibility that the "materiality" issue might be mooted after a trial here is a reason for *granting certiorari,* not denying it. As noted above, the widespread concern of the bar about the "integrity of management" standard stems in part from the fact that that oft consented-to test has not come, and is not likely to come, under judicial scrutiny.

In short, this case is ripe for review by this Court.

II

The government argues (Br. p. 8) that the Second Circuit's decision on "materiality" does not warrant review because it is correct.

Since the government talks about the charge in somewhat abstract terms, let us recall precisely what is and is not alleged to be the crime in this case.

The government (Br. p. 9) contends that in April and May, 1971, defendants "cheated" fifteen TDA stockholders (the so-called "ERD kickbacks") by refusing to "free-up" their restricted stock, engineering its sale to a third party, and receiving a portion of the proceeds.*

* The government (Br. p. 9) appears to suggest that petitioners received some $435,000. In fact, the indictment alleges that in the relevant period petitioners received some $25,000. (Jt. App. in the Ct. Appeals at 21) (The Second Circuit used a figure of $300,000, apparently to characterize petitioners alleged overall expected profit from the transactions. A 83, 102.)

But that alleged "cheating" is *not* the crime with which defendants are charged in the indictment; that crime, if it were a crime, was barred by the statute of limitations. Rather, petitioners are charged with failing to *disclose* their asserted April 1971 impropriety in a November 1971 *TDA* prospectus and a December 1971 *TDA* proxy statement.

The Second Circuit held that these ERD transactions were "material," and were required to be disclosed in TDA's filings, because they "may well" have been unlawful as a violation of Section 16(b). The government (Br. p. 9) rephrases this standard to say that the ERD transactions were "material" *to TDA's* filings because (a) petitioners were engaged in improper conduct and that impropriety reflected on the integrity of TDA's management; and (b) the alleged impropriety could have exposed TDA to private litigation.

Neither of the government's two formulations cures the analytic defects described in the petition.

At the time of the relevant SEC filings—*i.e.,* in November and December, 1971—petitioners were not convicted of, charged with, or even sued on the alleged wrongdoing of "committing" the ERD transactions. In fact, they continue vigorously to deny that their conduct was improper. Hence, under the government's "integrity of management" theory of materiality, petitioners were still compelled to draw a legal conclusion they dispute and then, on that basis alone, to disclose that conclusion, or the facts forming the basis for that conclusion, in later SEC filings. The government's interpretation of the Second Circuit's decision still would require "confessionals of mismanagement past and contemplated." *Limmer* v. *General Telephone & Electronics,* CCH Fed. Sec. L. Rep. ¶96,111 at 92,003 (S.D.N.Y. 1977).

The government's "integrity of management" test also is far too sweeping, and would bring within the ambit of

the securities laws *any* allegedly wrongful conduct, whether it be a violation of some federal (or even foreign) statute or state law doctrines of waste or breach of fiduciary duty. SEC Commissioner Karmel has correctly identified the problem with the scope of the "integrity of management" test:

> . . ., I am troubled by the sometimes articulated theory that any illegal act by management is necessarily material to an evaluation of that management's integrity, and therefore the failure to disclose such information violates the anti-fraud provisions. In particular, I am troubled by the notion that the SEC should be generally investigating suspected violations of federal or state laws other than the securities laws in order to compel disclosure by management of such other violations. Now that, of course, does not constitute an acceptance of corporate crime as a way of business. But corporations are subject to a myriad of federal and state laws, many of which are known to be honored in their breach. *If the SEC could investigate and compel disclosure of any business crime under a management integrity theory, the Commission could well have license to prosecute any public corporation in America.* R. Karmel, "Management Fraud—what are the Standards?" (Address, Annual Cooperative Securities Regulation Seminar) (October 27, 1978) at 17; emphasis added.

The decision below, even as now construed by the government, would accomplish precisely what Commissioner Karmel fears: it would license the prosecution of *any* business crime under the aegis of the securities laws —and that license would nullify all existing criminal statutes of limitation, tolling them until the corporate officer's last SEC filing.

The government's second asserted basis of materiality fares no better. To say, as the government does, that the ERD transactions were required to be disclosed, before there was any litigation on the subject, because they posed a risk of private suits for TDA is absurd because, as one court said, it would impose a "duty to disclose . . . not yet existent litigation." *Shapiro* v. *Belmont Industries, Inc.*, 438 F. Supp. 284, 292 (E.D. Pa. 1977). Under such a theory, for example, management would have a duty to "disclose" that it has engaged in transactions that *might*, some day in the future, be deemed an antitrust violation and *might* thereby someday expose the company to treble damage liability. Again, this theory would embrace nearly all asserted wrongdoing and extend the statute of limitations on an antitrust offense, for example, from four years to the date of an officer's last SEC filing.

Perhaps the best proof that the decision below is wrong —and confoundedly wrong—on the issue of materiality lies in this fact: The Second Circuit said that the ERD transactions were "material" to TDA because they created a potential *asset* for the company (the proceeds of defendants' alleged misdeeds "may well be immediately recoverable by TDA". (A. 102)) The government now says those transactions were "material" because they created a potential *liability* for TDA (potential TDA investors "certainly would have wanted to consider the future adverse consequences to the corporation of petitioners misdeeds . . . the Company . . . [was] expose[d] to large civil liabilities." (Br. p. 9))

Only an utterly unworkable and illogical standard of "materiality" could engender such contradictions.

III

The government ignores the fact that unlawful SEC criminal references have become widespread. It argues (Br. p. 12), instead, that the statutory framework permitting

the SEC to transmit evidence to the Attorney General (not to an assistant United States Attorney, as was done here), is a grant of authority to the SEC rather than a limitation on the powers of the United States Attorneys. The government wholly misconstrues the legislative framework. The pertinent statutes are a limitation on the power of the SEC to disclose *confidential* information derived in the course of a *private* investigation, and, quite properly, are intended to protect those who are the objects of an investigation. 15 U.S.C. §§77t(b) and 78u(e) (1975).

The government's reliance (Br. p. 12) on *United States* v. *Caceres,* 47 U.S.L.W. 4349 (April 2, 1979), is misplaced. The dispositive difference between *Caceres* and this case is that here the SEC violated an explicit statutory directive limiting its authority. In *Caceres,* the Court was careful to note, only a ministerial internal regulation of the agency was involved. 47 U.S.L.W. at 4352.

IV

On the issue of the government's misconduct: The government (Br. pp. 12-13) seeks to minimize the conflict between this case and *United States* v. *Rodman,* 519 F.2d 1058 (1st Cir. 1975) by urging, as it urged below, that the express agreement in *Rodman* and the prejudice occasioned by Mr. Rodman's self-incriminating statements are sufficient grounds of distinction. Petitioners still fail to comprehend how it is more egregious for the government to breach a contract (as in *Rodman*) than fraudulently to induce a contract (as was the case here). Further, the government in *Rodman* had stipulated not to use Mr. Rodman's incriminating testimony; thus there was no "prejudice." The distinctions which the government seeks to urge upon this Court have no basis in the facts or in law, and are made no more tenable by their repetition.

The government (Br. pp. 14-15) urges also that it was proper for the Court of Appeals not to "exercise a chancellor's foot veto over law enforcement practices of which it did not approve." But this is hardly the case for recalling that quotation from *Hampton* v. *United States,* 425 U.S. 484, 490 (1976). The district court here found that there was egregious government misconduct and that there was not available *any* effective remedy for such misconduct other than dismissal of the indictment.* Basic principles of fairness sometimes require a court to dismiss an indictment, Justice Cardozo said, because the constable has blundered. Here, the constable did not merely blunder; he acted wilfully and outrageously. Surely the district court had the discretion in these circumstances to dismiss the indictment.

* The government (Br. p. 5, fn. 5) tries to suggest that the misconduct was remedied: it suggests that the SEC cleaned house because the two SEC staff members who committed the fraud upon petitioners have "since resigned their positions with the government." In fact, one of those staff members left the SEC amicably, after a normal stint with the government, to join a prestigious firm, and *before* this case arose. The second, also after a normal stint with the government, left the SEC to form a law firm last year, and he was regaled with a farewell party by the staff. It appears that neither was ever censured or criticized by the SEC.

Petitioners respectfully urge that their petition for a writ of *certiorari* be granted.

May 25, 1979

Respectfully submitted,

SIMON H. RIFKIND
345 Park Avenue
New York, New York 10022
(212) 644-8000
Attorney for Petitioner
Douglas P. Fields

Of Counsel:

MAX GITTER
MAX FRIEDMAN
PAUL, WEISS, RIFKIND
WHARTON & GARRISON

NORMAN S. OSTROW
375 Park Avenue
New York, New York 10022
(212) 832-3611
Attorney for Petitioner
Alan E. Sandberg

Of Counsel:

FRANK WRIGHT
GRAND & OSTROW

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